DECEMBER 21, 2009 | BUSINESSWEEK.COM

BEST BUY, TECH TITAN | **CHINA'S CARBON SCHEME**

Bloomberg
BusinessWeek



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Henry Kravis and
George Roberts

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CEO Dunn and his blue crew aim to turn Best Buy stores into "digital playgrounds"

(COVER) PHOTOGRAPHS BY THOMAS BROENING; (THIS PAGE) BRAD TRENT

IN DEPTH

CAN KKR BECOME OMAHA ON THE HUDSON?

038 | Henry Kravis and George Roberts built their private equity giant on swashbuckling deals like the debt-fueled takeover of RJR Nabisco. Now they want a more diversified firm that can finance its own deals—just like Buffett's Berkshire Hathaway. |BW|

WHAT HEALTH REFORM WON'T CURE

046 | Obama and his allies in Congress say cutting waste and fraud will fund expansion of health coverage. But proposed legislation barely nods to the problem, and medical suppliers who have overbilled the feds for billions aren't likely to change their ways. |BW|

WHY TECH BOWS TO BEST BUY

050 | As the last consumer electronics giant standing, Best Buy has unparalleled clout. Now CEO Brian Dunn wants to go beyond selling products like TVs and computers and become a central player in determining what kind of products come to market. |BW|



CHINA'S 'MADE IN CHINA' PROBLEM

Beijing's massive stimulus helped boost demand for commodities such as steel. It also led to a boom in new factories and a glut in output. Experts fear trade friction could increase if China starts exporting the excess at cut-rate prices. | BW | PAGE 020



HANDLING A WOUNDED TIGER

Many sponsors are standing behind him, in part because there is no one who can replace him. But the public will never look at this endorser the same way again. | BW | PAGE 036

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(LEFT TO RIGHT) STRINGER SHANGHAI/REUTERS; DIANE BONDAREFF/POLARIS

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THE BUSINESS WEEK

EDITED BY HARRY MAURER & CRISTINA LINDBLAD



Obama wants to use the budgetary leeway from TARP repayments for a new jobs program

ECONOMICS & POLICY

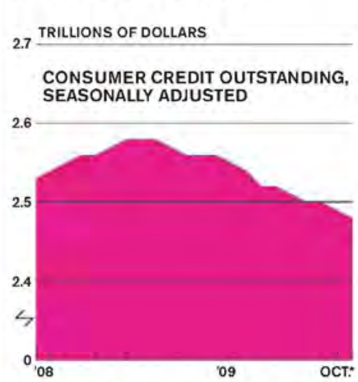
OF TARP AND JOBS

"There has rarely been a less loved or more necessary emergency program than TARP," said **President Barack Obama** to an invitation-only **Brookings Institution** audience on Dec. 8. The **Treasury Dept.'s** $700 million bailout program continues to bedevil politicians' approval ratings, though an often critical watchdog, the **Congressional Oversight Panel,** confirmed it has proved effective. **Bank of America's** Dec. 2 announcement that it plans to return $45 billion in TARP cash left **Citigroup** and **Wells Fargo** as the only two giants that haven't repaid, and the two banks are clamoring for terms under which they, too, can make good—and thus escape federal executive-pay strictures. In a Dec. 9 letter to Congress, **Treasury Secretary Timothy Geithner** extended TARP through next October but said he expected bank repayments to reach $116 billion "soon" and total $175 billion by the end of 2010. He added that the bailout would ultimately cost taxpayers at least $200 billion less than projected as recently as August.

Geithner pledged that going forward, the program would focus on slowing foreclosures, sparking more community-bank lending to small business, and supporting consumer credit. Meanwhile, the White House wants to use the budgetary savings to bolster the President's Dec. 8 demand for new job efforts to beef up this year's $787 billion stimulus program. At Brookings, Obama proposed another extension of unemployment benefits, more public-works spending, and additional aid to state and local governments. One high-profile element, dubbed "cash for caulkers," would award tax rebates for improving home energy efficiency, potentially up to $12,000 per homeowner. Deficit-conscious Republicans slammed the proposals, with Arizona **Senator John McCain** arguing that the use of bailout savings for jobs is akin to a "slush fund." Other GOP leaders demanded a TARP shutdown by Dec. 31.

|BW| PAGE 013 **"Tim Geithner Is Starting to See Daylight"**
PAGE 026 **"TARP: Last Bank Out Is a Rotten Egg"**

PARING BACK



Data: Federal Reserve *Preliminary

A HEALTH-CARE DEAL

Senate Majority Leader Harry Reid (D-Nev.) may at last have

$896 million

Amount Britain's Treasury expects to raise by taxing banks 50% of all bonuses to employees

(OBAMA) SUSAN WALSH/AP PHOTO; (SOTOMAYOR) ALEX WONG/GETTY IMAGES; CHART BY ALBERTO MENA/BW



a health-reform bill that 58 Democrats and two independents can bring themselves to vote for. A delicate compromise, announced on Dec. 8, aims to give all sides a slice of what they want. The public option—the government-financed health insurer that **Obama** had pushed—is gone. Instead, the federal **Office of Personnel Management** would be authorized to negotiate with private insurers to offer national health plans, instead of the state-by-state plans primarily available now. Americans aged 55 to 64 would be allowed to buy into **Medicare,** which would help the estimated 2 million to 3 million people in that group who are out of work and unable to afford private insurance. Now, Reid is banking on a favorable cost estimate from the **Congressional Budget Office,** which would enable him to move the bill to the floor for debate during the week of Dec. 14.

"Democrats Said to Agree to Drop Public Option" businessweek.com/magazine



Sotomayor: Her ruling went against business

JAPAN BACKS OFF

In a step back for free-market reform in Japan, the **Democratic Party,** elected in August, won parliamentary approval on Dec. 4 to scrap a plan to privatize **Japan Post,** the vast, stodgy postal-services agency where many citizens stash their money. The move infuriated allies of former **Prime Minister Junichiro Koizumi,** who won a second term backing postal reform in 2005. With assets of $3.4 trillion and a reputation for inefficiency, Japan Post stifles competition in financial services and hobbles the economy, say the critics. Meanwhile, on Dec. 8, **Prime Minister Yukio Hatoyama's** government passed a new, $81 billion stimulus package. There's little doubt of its necessity: On Dec. 9 the **Cabinet Office** revised its July-September GDP growth figure to an annualized 0.3% from an earlier estimate of 1.2%, citing skimpy corporate spending.

"Japan Unveils Another Stimulus" businessweek.com/magazine

SOTOMAYOR'S DEBUT

The first opinion penned by **Supreme Court Justice Sonia Sotomayor** won't please Corporate America: In ***Mohawk Industries v. Carpenter,*** she ruled that instead of holding back sensitive internal documents while appealing court rulings to disclose them, companies must respect orders from the bench immediately and file any complaints after the litigation is finished. That broke no new legal ground, but the 9-0 ruling—traditionally, a new Justice's

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008 EXECUTIVE SUMMARY



In Copenhagen: A U.S. move on greenhouse gases may push an accord

ADRIAN DENNIS/AFP/GETTY IMAGES

first opinion is rendered on a unanimous decision—may signal future fireworks between Sotomayor and conservative **Justice Clarence Thomas.** He signed part of the opinion but bristled at what he sensed was a value judgment, rather than a legal interpretation, in a section of the ruling in which she explained out how she came to her conclusion.

SHAKY GREECE

Could Greece become the first euro zone country to slide into default? **Fitch Ratings** cut the country's sovereign rating on Dec. 8 to BBB+, the third-lowest investment grade. A day earlier, **Standard &Poor's** put Greece on its watch list for possible downgrades. With the government budget deficit likely to top 13% of GDP this year, it's no wonder investors are fretting. European Union officials say they will step in if Greece can't put its house in order.

| BW | PAGE 034 "Greece Rattles the Euro Zone"

OBAMA'S GREEN GAMBIT

When it comes to global warming, who needs Congress? As the 192-nation Copenhagen climate summit convened on Dec. 7, **President Obama** strengthened the U.S. hand when his **Environmental Protection Agency** said it would clamp down on greenhouse gases under the **Clean Air Act.** Washington's new commitment boosts chances that nations will agree to specific emissions targets in Copenhagen—though a legally binding accord will be left for later—and that wealthier countries will agree to hand billions of dollars to poorer ones to help them get greener. The EPA's action also puts more pressure on Congress to act, since just about everyone in the U.S., from business groups to environmentalists, prefers climate legislation to regulatory action.

| BW | PAGE 018 "China: Climate Change or Hot Air?"

STRATEGY

TOYLAND TROUBLE

Prospects for the wildly popular **Zhu Zhu Pets,** which resemble real hamsters sans smell and bother, took a dive when consumer group **GoodGuide** announced on Dec. 5 that one toy it tested contained illegal levels of antimony, a toxic metal. False alarm, said the **Consumer Products Safety Commission** two days later: The critters meet all federal standards. GoodGuide quickly backtracked and apologized, explaining that it used a testing method different from—and not comparable to—the feds' approach.

FINANCE

SUBPRIME FALLOUT

Go-go mortgage lender **New Century Financial** went bankrupt in April 2007—an

THE *BUSINESSWEEK*/ YOUGOV OPTIMISM METER

LESS GLOOM OUT THERE



The Optimism Meter, a proprietary measure of sentiment and expectations, economic statistics, and market forecasts, gained 2 points in the week ended Dec. 8, to 44, as 15% more people said they believe the economy is improving and the share who think things are getting worse dropped to a two-month low. Developed to track shifts in outlook among individuals, professional investors, and economists, the meter gauges optimism about jobs, markets, and growth.

*Calculated using consumer polling, economic forecasts, and financial markets data; 0=lowest and 100=highest
Data: YouGov, *Bloomberg BusinessWeek*

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early indicator of the coming catastrophe in the subprime sector. Nearly three years later, the legal ramifications continue to unfold: On Dec. 7 the **SEC** filed civil suits against three former executives, alleging securities fraud. The agency says New Century co-founder and **CEO Brad Morrice, CFO Patti Dodge,** and **Controller David Kenneally** failed to disclose key information, including dramatic increases in loan defaults and repurchase requests from mortgage investors. Morrice collected the negative news in internal reports he titled "Storm Watch," says the complaint. It adds that in 2006, Dodge and Kenneally altered New Century's accounting for loan repurchases in violation of generally accepted accounting principles. A lawyer for Morrice stated the charges are "flatly false," while attorneys for Kenneally and Dodge said they had done nothing wrong and would defend themselves against the allegations.

TECHNOLOGY

REAL-TIME SEARCH

Google finds itself in an unfamiliar position: playing catch-up in the realm it dominates. On Dec. 7, Google launched a feature that merges the frequent updates made by users of social sites **Facebook, MySpace,** and **Twitter** with its general Web search results. Now, users looking for info on fast-unfolding events, such as the Iranian election protests, can scan through messages posted in the past few seconds rather than rely on indexed articles or sites that may already be outdated.



All eyes on Google: The search king will hook up with social networkers

In October, **Microsoft** connected its **Bing** search engine to Twitter in a similar fashion, but Google's deal with **News Corp.'s** MySpace is a first. Google also said on Dec. 4 that regular search results will be custom-tailored based on each user's surfing history.

▸ **"Google Gets Real-Time, Personalized Search"**
businessweek.com/magazine

IDEAS ARE INDEPENDENT RESEARCHERS AN ENDANGERED SPECIES?

Way back in 2002, the **SEC** and then-**New York Attorney General Eliot Spitzer** grew alarmed about conflicts of interest on Wall Street. A series of scandals convinced them that the supposed Chinese wall between research analysts and other staff at investment banks was all too porous: Researchers tended to sing the praises of companies that gave the banks plenty of other business, or make buy/sell calls that would help traders sell stocks.



The result: A $1.4 billion settlement. As part of the deal, 10 big Wall Street firms spent $430 million over five years on research from independent firms. That accord expired in July, as a Dec. 6 article in the *Financial Times* points out—pulling the rug out from under the independents, whose revenues have been tumbling much faster than the rest of Wall Street's. **Sanford Bragg,** head of **Integrity Research Associates,** which tracks the industry, estimates that in 2009, asset managers will spend $1.67 billion on research from independents, down 18% from the previous year. Investment banks, on the other hand, will sell a fat $9.7 billion worth of research, down just 10%. And of 1,115 independents that Bragg tracks, 131 are no longer operating, up from 76 a year ago. Says one independent about the impact of the settlement expiring: "We have to start over from scratch."

▸ *The Financial Times*

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FACETIME | AL HUNT





DAVID BURNETT/CONTACT PRESS IMAGES

TIM GEITHNER IS STARTING TO SEE DAYLIGHT

While the Troubled Asset Relief Program is winding down, it will still be used to aid small banks. On Dec. 9, Treasury Secretary Tim Geithner exercised his option to extend the TARP bailout program until October 2010. And according to Bloomberg.com, House Majority Leader Steny Hoyer has suggested that lawmakers may seek to finance job-creation measures with unused TARP money. In a talk with Bloomberg TV's Al Hunt on Dec. 4, Geithner spoke about the unemployment crisis and the debate over so-called Tobin taxes, a proposed global levy on financial transactions to discourage destabilizing speculation. Here are excerpts from the interview.

AL HUNT

Unemployment has dropped to 10%. Do you believe the jobs market has now turned?

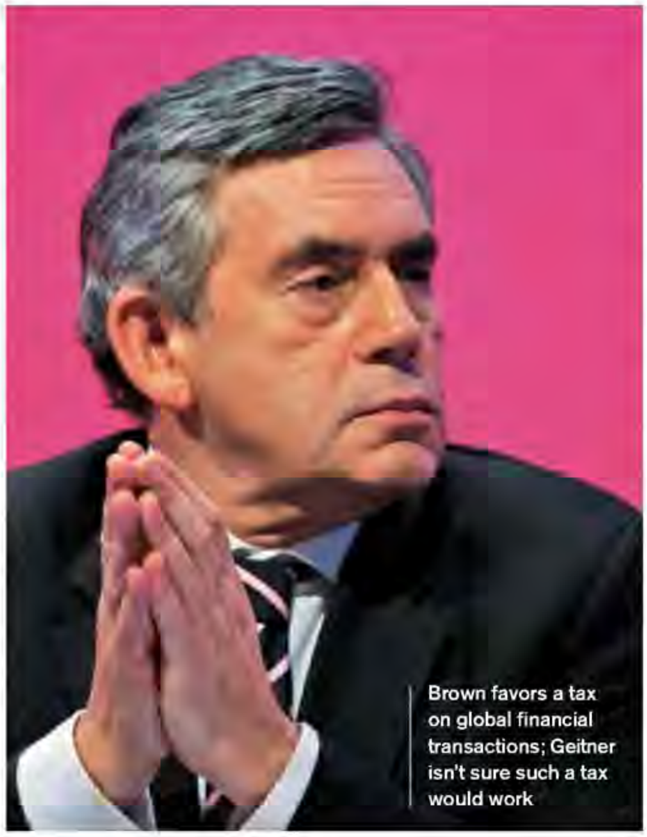
TIMOTHY GEITHNER

There's been progress, but not good enough. The key test is when you see companies across the country start adding to payrolls. There are hopeful signs—pockets of real strength in technology and exports—but we've got a ways to go.

What is the probability that the jobless rate will be below 10% a year from now?

Quite high.

You said there's a pretty good case for a tax credit for hiring new workers. [Former Deputy Treasury Secretary] Roger Altman, your friend and philosophical soul mate, has written that there should be a $5,000 employer credit for each net new job. That might add as many as a million and a half new jobs. Can you support that?
The President is looking at a range of ideas, including tax incentives to spur job creation and hiring. But just to be frank about it, there are a lot of people in the business and academic communities who are not confident that this particular proposal would be that powerful.


Brown favors a tax on global financial transactions; Geitner isn't sure such a tax would work

So you don't think it would add a million and a half jobs?
Personally I wouldn't associate myself with any estimate of what these things might actually do. That's just too hard to judge. We're taking a look. But I wouldn't say right now we're confident that [this proposal] is going to provide the most powerful bang for the dollar.

The Tobin tax is a levy on global financial transactions once favored by Larry Summers, now pushed by Gordon Brown, Warren Buffett, and others. You've been a naysayer, I thought. But House Speaker Nancy Pelosi said after a conversation with you that you are now open to the idea. Are you?
What I'm open to is looking at a range of different ways of achieving its objective.

> I wouldn't say...we're confident that [a hiring tax credit] is going to provide the most powerful bang for the dollar

You're saying that the Tobin tax is not a very workable idea?
Yes. I have not seen a version that I think works.

You were the head of the New York Fed in the middle of the financial crisis. Some Goldman Sachs executives have recently said their firm would have been O.K. without assistance from the Federal Reserve and others last year. Is that your view?
My view is this: The entire U.S. financial system, all the major firms, and even small banks were at that moment in the middle of a classic bank run. I think the system was at risk and none of the big institutions would have survived a situation in which we let that fire try to burn itself out.

A number of banks and firms that have repaid the government are planning record yearend bonuses. Is that O.K. with you?
No, our judgment is we have to end that era of irresponsibly high bonuses that helped create the incentive for excessive risk-taking. We want to see fundamental constraints on how senior executives are paid at these institutions so that their compensation is much more tied to long-term gain.

As we mentioned, you were president of the New York Fed. And big banks have a major influence in selecting that person. Given the enormous importance of that job, shouldn't the head of the New York Fed be appointed by the President subject to Senate confirmation?
I would be completely supportive of the Congress taking a look at that ... because you do not want to have any public institution in the position where its judgments may be viewed as subject to the influence of the financial community.

Does the Obama Administration have a clear, coherent economic message?
Our responsibility is to make sure that we repair what is broken in this economy ... and do all those things critical to creating the kind of environment in which private business can flourish. This crisis not like anything we've seen before because of the intensity of the financial fire. But the problems America faces today are not just because of the recession. They are the result of a sustained period where we saw public policy just not doing what needed to be done.

Most experts from Wall Street and academia give you high marks for understanding the policy matters that confront the Treasury. You really know this stuff. Let me ask you to give yourself a grade as chief economic spokesman for this Administration.
Look, I'm a tough grader. I have a good awareness of things that I'm reasonably good at and the things that I'm going to work very hard to get better at.

You're not quite at the A level yet?
No. I would never give myself an A on anything. | BW |

TOBY MELVILLE/REUTERS



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THE NEW BELIEVERS IN THE CORNER OFFICE

Wall Street has been on a tear for months. But now green shoots of optimism are sprouting among corporate managers. That could improve prospects for a sustainable rebound

John Maynard Keynes used the phrase "animal spirits" in 1936 to highlight the role confidence plays in the economy. He saw how investors and businesspeople must go with their guts in uncertain times and put their money to work if the economy is to grow and the nation to prosper. Judging by the recent surge in the stock market, animal spirits are certainly back on Wall Street. Undeterred by worries a bubble may be building, investors have piled into equities, pushing the Standard & Poor's 500-stock index up about 60% since March.

In the executive suites of Corporate America, however, confidence has been slower to return. Shell-shocked by the worst recession since the 1930s, company chieftains have been focusing on survival rather than expansion. That caution has held the economy back as businesses have kept tight control over hiring and spending.

Now, though, the gloom looks to be lifting. That should give legs to the recovery and reduce the risk of a relapse into recession next year as stepped-up business spending offsets the fading impact of the $787 billion federal stimulus plan.

52,000

Number of temporary workers added in November, the most since 2004

Data: Labor Dept.

Behind the revival: a pickup in profits. Earnings surged 11% in the third quarter from the second, the most in five years. Sure, most of that gain came from much-improved results in the banking industry. But even after stripping out financials, U.S. domestic profits eked out a 2% gain.

Even better times may lie ahead. More than two-thirds of corporate execs surveyed in November by the Business Roundtable expect their company's sales to increase over the next six months. And the Roundtable's CEO Economic Outlook Survey Index—designed to take the temperature of its 160 member corporations—rose to its highest level in more than a year in the fourth quarter (chart).

More telling than what company bosses are saying is what they're doing. Rather than focusing solely on cost-cutting, executives are preparing for growth by looking to hire workers, add to inventory, and build capacity.

Employers pared payrolls by just 11,000 last month, the smallest reduction since the recession began in December 2007. The breadth of the declines narrowed as well, with the fewest industries since May 2008 saying they had cut workers. And companies added to the hours of existing employees and took on temporary workers, steps that usually presage the hiring of permanent, full-time staff.

A survey by Manpower, the world's second-largest provider of temporary workers, finds that employers plan to increase payrolls for the first time in a year during the first quarter of 2010. Seven of the 10 industries polled, including retailers and business services, expect to take on new workers.

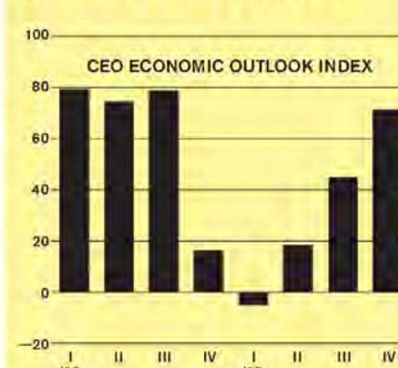
Companies also may be starting to raise inventories so as not to lose out on sales. Stockpiles at factories and wholesalers rose for the first time in 14 months in October. While some of the gain at plants was due to a rise in the price of petroleum inventories, stocks of many other goods, from aluminum to automobiles, also increased.

A shift in stockpiling strategy would be significant. Companies must cut production to trim inventories. Businesses have slashed inventory nearly 7% since the end of 2007, more than the 3.7% fall in gross domestic product during the recession. If companies are finally turning from reducing to rebuilding stockpiles, that could goose growth well into 2010.

Business spending on equipment and software is another piece of the growth puzzle beginning to fall into place. During the second quarter, such outlays added to GDP for the first time in a year and half. And 40% of CEOs surveyed by the Roundtable expect their capital spending to grow over the next six months; only 16% see declines.

Of course, not all is copasetic for companies. Small businesses, depressed by falling profits and slow sales, saw their confidence hit a four-month low in November. And even their larger brethren don't see a barn-burner of a recovery. Executives told the Roundtable that they expect the U.S. economy to grow just 1.9% in 2010. That's not much of an upswing, but it sure beats a double dip back into recession. | BW |

BUSINESSES TURN UPBEAT ON THE OUTLOOK



Data: Business Roundtable

(TOP TO BOTTOM) PHOTOGRAPH BY CHRIS USHER; CHART BY ALBERTO MENA/BW

NUMBERS

IN MOST OF AMERICA, HOME PRICES CREEP UP

By Tara Kalwarski/Charts by David Foster

Residential real estate prices have increased by about 5%, adjusted for inflation, since the end of the first quarter. As the inventory of existing homes for sale shrinks, a housing recovery could solidify. Sales have increased sharply in some of the hardest-hit states.

A Lost Decade: Although home prices have been rising since March, after adjusting for inflation they are only at levels first reached in 2001.



Data: Bloomberg, S&P/Case-Shiller U.S. National Home Price Index, Bureau of Labor Statistics

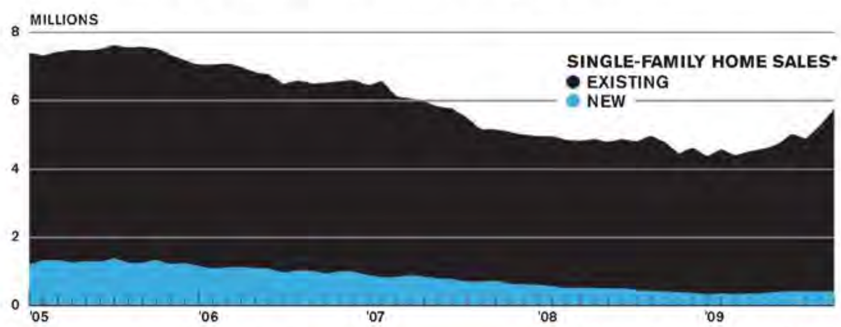
City Slide: Prices in expensive metro areas have fallen more than the 11% U.S. average.

PRICIEST REAL ESTATE MARKETS

METRO AREA	MEDIAN HOME PRICE IN THOUSANDS*	ESTIMATED ONE-YEAR % CHANGE
San Jose	$566	-12.9%
San Francisco	$538	-12.6%
Anaheim, Calif.	$499	-3.3%
New York	$450	-13.9%
Stamford, Conn.	$398	-15.6%

Data: National Association of Realtors *As of Q3 2009

Fewer New-Home Sales: Existing homes now make up about 93% of all sales, vs. a long-term historical average of about 85%.

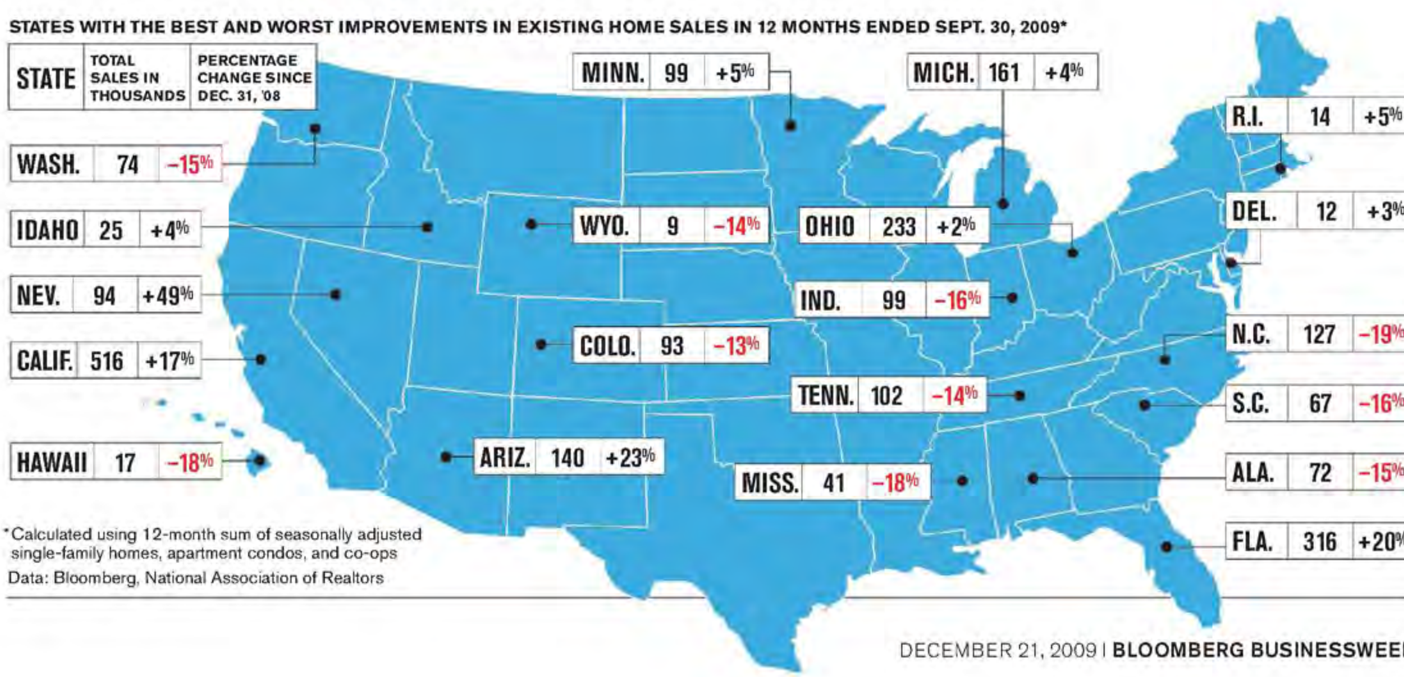


Data: Bloomberg, U.S. Census Bureau *Seasonally adjusted annual rates

SIGNS OF LIFE IN THE SUNBELT—AND ELSEWHERE

Four states—Nevada, Arizona, Florida, and California—have seen double-digit increases in sales volumes for existing homes since the end of 2008.

STATES WITH THE BEST AND WORST IMPROVEMENTS IN EXISTING HOME SALES IN 12 MONTHS ENDED SEPT. 30, 2009*



*Calculated using 12-month sum of seasonally adjusted single-family homes, apartment condos, and co-ops

Data: Bloomberg, National Association of Realtors

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NEW BUSINESS

CHINA'S CARBON-CREDIT HUSTLE

The mainland earns billions in carbon-offset sales. But by raking in cash for projects that would have been built anyway, it may not be playing by the rules

By Ben Elgin and Bruce Einhorn

On the wooded hills outside the city of Harbin in the northeastern province of Heilongjiang, Chinese developers are building towering wind turbines that will spin day and night to generate clean electricity. The project represents the hope that China, which recently surpassed the U.S. as the world's largest source of greenhouse gases, has truly embraced environmentalism.

The planned 29 turbines near Harbin represent something else as well: the widely accepted notion that market forces can be harnessed to aid the fight against climate change. Under the international treaty known as the Kyoto Protocol, Chinese wind-power developers are selling "carbon credits" reflecting their reductions in emissions of carbon dioxide and other heat-trapping gases.

Corporate and government buyers from industrialized countries pay for the credits as a way of complying with the Kyoto climate-change rules. The funds generated are supposed to encourage additional green-energy projects without forcing owners of older factories and power plants to close down their facilities or undertake expensive renovations. Credits sold under the Kyoto pact generated nearly $7 billion worldwide last year. Beijing has collected almost two-thirds of the total carbon revenue flow since 2002.

Unfortunately, wherever they have been used, carbon credits have been subject to manipulation. On Dec. 4 the U.N. committee that oversees the international credit trade refused to approve 10 Chinese wind farms, including the Harbin complex. The U.N.'s concern is that the Chinese projects would have been built even without the proceeds from credits.

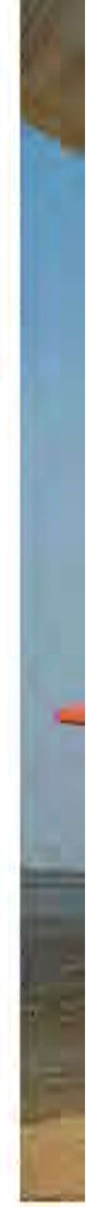
If that's correct, the sale of credits would not stimulate production of any additional clean energy. Credit purchasers would receive empty environmental bragging rights, and the Chinese developers would obtain an undeserved windfall. "This is 21st century climate-policy snake oil," says Michael Dorsey, a professor of environmental studies at Dartmouth College.

Officials at China's National Development & Reform Commission, which oversees the country's ambitious-sounding goals to expand renewable energy use, didn't return repeated phone calls seeking comment on the U.N. decision.

OFFSETS WITHOUT BENEFITS

Despite the potential for exploitation of the carbon market, representatives of 192 nations are discussing ways to expand it at the U.N. climate summit in Copenhagen, which runs through Dec. 18. The U.S. Senate, meanwhile, is poised to consider sweeping environmental legislation early next year that includes provisions allowing corporations to avoid certain pollution-

Critics say Chinese developers don't deserve their windfall since the credits they sell don't stimulate additional clean energy production





reduction mandates by purchasing carbon credits.

Since the Kyoto Protocol was signed in 1997, many economists, environmentalists, and politicians have endorsed the idea that selling various types of carbon credits (also known as offsets) provides an efficient means of directing funds to the most feasible clean energy projects around the world. A number of credit-trading systems now exist; the U.N. supervises those that operate under the Kyoto accord.

Their success, however, is predicated on the credits stimulating activity that would not have occurred without special financial incentives. David G. Victor, a professor at the School of International Relations and Pacific Studies at the University of California at San Diego, estimates that between one-third and two-thirds of all carbon credits awarded to developing countries under the Kyoto agreement have rewarded developers whose projects would have been built without the carbon funding. "Carbon offsets offer this promise of letting you have your cake and eat it, too," says Michael W. Wara, a Stanford University law professor specializing in environmental policy. "The problem is they don't work very well."

GAMING THE SYSTEM?

The 10 Chinese wind farms were rejected, in part, because U.N. officials fear Beijing is actually reducing its financial support for wind power as a gambit to help the country's clean-energy projects qualify for carbon payments from abroad. The Chinese government may be doing this by cutting the rates the wind farms will be paid for electricity, according to the U.N. officials.

The Harbin wind farm's developers initially estimated the project would earn an annual profit of 8.76%. That would have made the wind farm ineligible for carbon funds, since the cutoff to benefit from credit sales is 8%. The Chinese government apparently responded to the situation by reducing what it had been expected to pay for Harbin's electricity, pulling the project's profit margin below 8%.

Shandong Province: China is moving fast to build wind power capacity

On Dec. 4, the U.N. announced that it would stop what appears to be China's attempt to game the system. Lex de Jonge, chairman of the U.N. committee overseeing carbon credits, said in a statement that his panel "must safeguard the environmental integrity of the [carbon market]." He added: "This means registering only projects that would produce emission reductions that are additional to those that would take place without the project."

Some wind-power financiers who

WANG XIAOGUANG/IMAGINECHINA/ZUMA PRESS

stand to benefit from a robust carbon market dispute the U.N.'s rationale. Rejecting carbon credits for the Chinese projects, they say, will scare off investors in renewable energy. "Without those revenues [from credit sales], a lot of investors would pull out," says Steve Lyons, general counsel for China Wind & Energy, a Hong Kong company that helps develop wind farms in China. "For international developers, the return absolutely would not be high enough without the carbon credits."

FLARE-UP IN NIGERIA

Beijing may not be the only government retreating from a pro-environment position out of a desire to generate lucrative carbon credits.

Nigeria is encouraging the government-owned Nigerian National Petroleum Corp. and other oil companies to seek credits for reducing the flaring of natural gas, a by-product of oil drilling. The flaring generates large amounts of heat-trapping gases that contribute to climate change.

But gas flaring is already banned in Nigeria. Now the national oil company is lobbying against new legislation that would reinforce the prohibition so that the country can cash in on carbon credit sales. Nigerian National Petroleum's general managing director, Mohammed S. Barkindo, defended the strategy at a November conference in Abuja on climate change. "Any act or law introduced to stop gas flaring," he said, "will erode the...criterion of getting any project registered" with the U.N. to sell credits, according to the Nigerian publication *NEXT*.

Levi Ajuonuma, a spokesman for the national petroleum company, says it is looking for the best way to reduce flaring. "The primary motives for pursuing [carbon credits] are not financial," he says. "They are environmental."

University of California professor Victor warns, however, that the distorting effects of trading carbon credits are only beginning. "We shouldn't be surprised," he says. "The incentives to do this are worth billions of dollars." |BW|

–With Mark Scott



STRINGER SHANGHAI/REUTERS

CHINA'S 'MADE IN CHINA' PROBLEM

The downside to Beijing's huge stimulus is a glut of factories and output that may spur trade frictions

By Dexter Roberts



BEIJING

It's been a rough year for Inner Mongolia Baotou Steel. Revenues for the company, based on the windswept grasslands 350 miles northwest of Beijing, are off by 21%, and the steelmaker is likely to book its first loss since going public nearly a decade ago. Slowing exports have hurt, but the biggest problem has been surging output at home. Chinese steel production is up 10.5% this year, and capacity is on track to exceed 700 million metric tons annually—about 200 million more than China consumes. "[Overcapacity] is affecting every company in the industry," says Yu Chao, Baotou's investor relations chief. "We have no choice but to accept this."

Can this be the same China that's expected to grow by more than 8% this year? While Beijing's $586 billion stimulus package has helped the mainland navigate the global financial crisis, there's a downside. Fixed asset investment—money spent on factories, highways, and other big-ticket projects—soared 40% in the first half and accounted for nearly all of the country's growth.

The easy credit helped boost demand for commodities such as steel, chemicals, and glass. But it also led to a boom in new factories to make those goods. That may increase trade frictions if China starts exporting the excess at cut-rate prices—what trade experts



Finished steel coils in Shanxi Province: China's output is up 10.5%

call dumping. With the mainland's steel production capacity outstripping domestic demand by nearly 30%, "will they shut those plants down and lay those people off, or export their way out of it?" asks Daniel R. DiMicco, CEO of Charlotte-based steel producer Nucor. "Their tendency is to export."

China's state planning agency is warning of massive overcapacity in a half-dozen industrial sectors. Cement makers have added 600 million tons of annual production capacity this year to the 1.9 billion tons China already had. Aluminum smelters are running at only two-thirds capacity vs. nearly four-fifths last year. And over the past two years the number of Chinese companies making wind power equipment has quadrupled to more than 80.

RISK OF LOAN DEFAULTS

Washington is starting to take action. China now faces duties that nearly double the price of tubular steel exports to the U.S. after the Commerce Dept. issued a preliminary ruling that Beijing is dumping the tubes, which are used in the oil industry. "China keeps adding capacity even though there's no need for it anywhere in the world," says Roger Schagrin, a Washington lawyer representing American steelmakers in the tube complaint. He says Chinese exports of tubular steel to the U.S. tripled over the last three years to 2.1 million tons annually, though the surge has slowed since the ruling. American manufacturers of coated paper have filed a similar complaint.

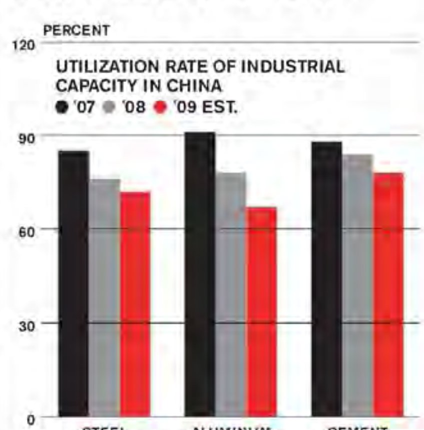
Beijing, too, is concerned about the industrial glut. If companies adding capacity can't sell their extra output, they risk defaulting on their loans. And plans to wean China off state spending, creating a more consumption-driven and innovative economy, could suffer if companies continue to overinvest in commodity production. "We need to think about what our economy should rely on," says Zha Daojiong, a professor at Peking University's School of International Studies. "Low prices and large quantity or higher value-added products?"

Beijing has shown little willingness to revalue the yuan, so China's excess goods will remain cheap around the world

China has taken some steps to rein in the expansion. The state planning agency is limiting new projects in the cement, aluminum, and glass industries that don't meet strict standards for pollution control, energy efficiency, and size. It has ordered two top steel producers, Shanghai's Baosteel and Wuhan Iron & Steel, to stop building a pair of mills with annual capacity of 10 million tons each. And it has banned construction of smaller factories making polysilicone (used in solar cells) and silicone monomer (used for everything from skin lotions to electronics). "We like what the Chinese government is doing: They're focusing on who is using resources efficiently," says Tom Cook, Greater China chief at Dow Corning, which may see some smaller rivals shut down due to the rule changes.

That doesn't mean it will be easy to fix the problem. Most companies in the hardest-hit industries are big employers, state-owned, and a key source of revenues for regional governments. As such, they enjoy subsidized energy and land—not to mention close ties to local banks—so adding new capacity can be a breeze. When other countries could afford to buy the surplus, "China got away with it ... but now it's a pressure cooker with steam coming out," says Joerg Wuttke, president of the European Union Chamber of Commerce in China. His group on Nov. 26 released a report on overcapacity that predicts growing trade frictions.

BIGGER SERVINGS, SMALLER APPETITE



Data: European Chamber of Commerce in China, Morgan Stanley

And China may not be willing to make the macroeconomic changes required to face up to the challenge. At Beijing's annual policy-setting conference on Dec. 7, the government hinted that its spending would continue to drive growth for at least a year. Officials have also shown little willingness to revalue the currency, the yuan, so China's surplus output will continue to be relatively inexpensive on the global market. "Some countries are calling for yuan appreciation while imposing trade protectionism on China, which is unfair and actually limits China's development," Premier Wen Jiabao told European officials at a Nov. 30 meeting in Nanjing.

Chinese economists, meanwhile, argue that growth eventually will eat up any excess production. "In a competitive environment, overcapacity is inevitable," says Lu Feng, a professor at Peking University's China Center for Economic Research. In normal times, that doesn't usually create the trade spats and other concerns now faced by China. But these are hardly normal times, says Xiong Bilin, an official from the state planning agency's Industry Dept. "The global financial crisis," Xiong says, "has made this problem even more pronounced." |BW|

—With Nanette Byrnes, Steve LeVine, Charlotte Li, and Mark Drajem

RAGING AGAINST THE STREET

How mad is Main Street at Wall Street? A new Bloomberg National Poll indicates a furious backlash is brewing

By Alison Fitzgerald

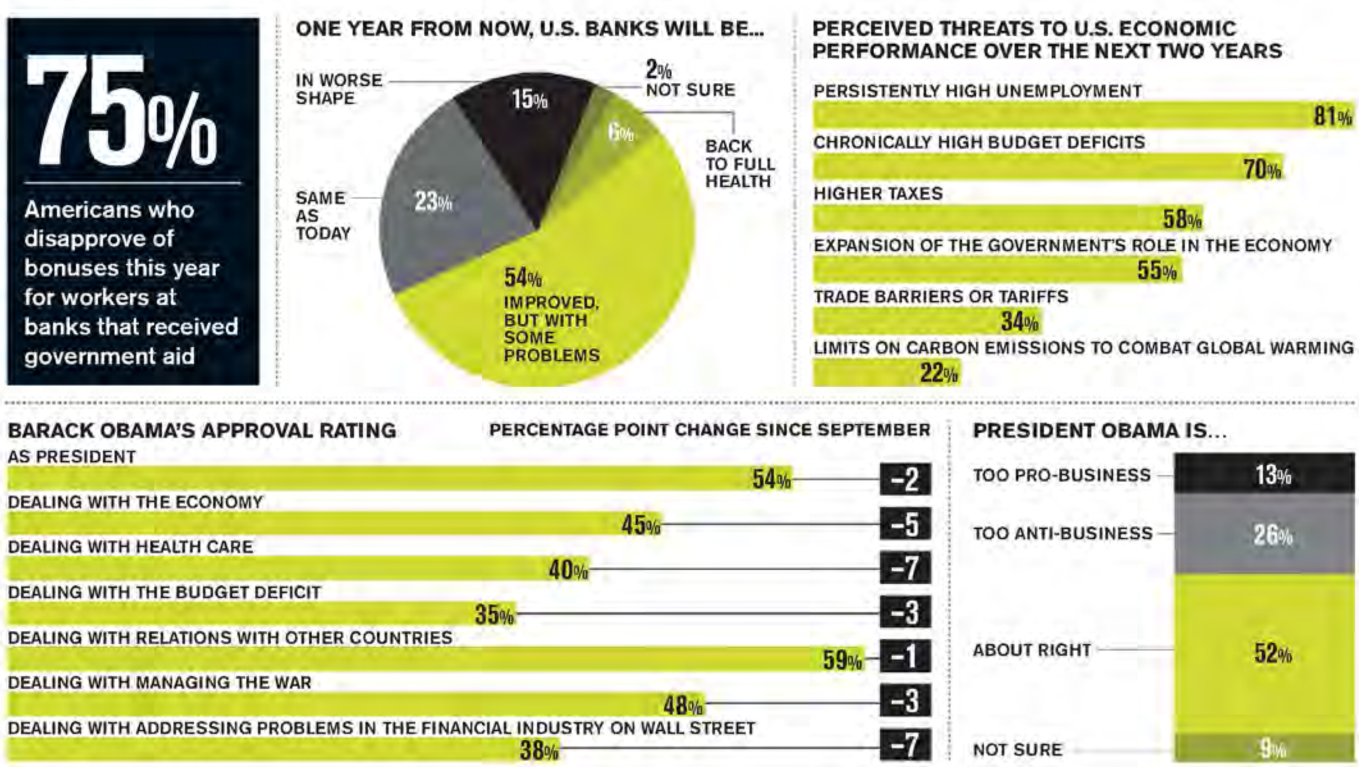
Wall Street firms are recovering—but their standing with the American public is not. The public rage directed at Wall Street banks and brokerages remains at high levels, according to a Bloomberg National Poll of 1,000 U.S. adults conducted on Dec. 3-7 by the Des Moines firm Selzer & Co. Two-thirds of Americans say they have an unfavorable view of financial executives. More than half say big financial companies, which are expected to pay record yearend bonuses, are out only to enrich themselves and also should not have received government aid.

Banks that got taxpayer help through the Troubled Asset Relief Program—the $700 billion financial rescue plan passed by Congress last year—shouldn't pay any bonuses, according to 75% of those polled. And this includes 39% of respondents who say they disapprove of bonuses even when the banks have paid the government back. "The fact that they're even in existence should be bonus enough," says Cassie Swihart, a 58-year-old retired registered nurse from Warsaw, Ind. Adds Elijah Brown, 42, an unemployed union contractor from California: "Why would you want to give somebody a bonus who put us into this situation?" Brown is among the 64% of people who said bailing out banks was a bad idea.

Many large banks have roared back to profitability as the financial markets and broader economy have recovered this year. Goldman Sachs, Morgan Stanley, and JPMorgan Chase's investment banking unit will hand out a combined $29.7 billion in bonuses, according to analysts' estimates. That's a record, beating the $26.8 billion in 2007—and up 60% from last year, when all three banks took billions in support from the Treasury to weather the financial crisis.

The Bloomberg poll also questioned Americans about the Obama Administration's performance, the challenges confronting the economy heading into 2010, and the war in Afghanistan. Below is a sampling of the results. For the full poll data, go to **bx.businessweek.com/obamas-economic-policy/reference/** BW

AMERICA THE SKEPTICAL



CHARTS BY DAVID FOSTER/BW



In the face of an unstable economy and an uncertain future, businesses are concerned about how they will navigate the coming months and importantly, how to identify and plan for a new set of risks.

We believe that quality business insurance has never been more important, or offered more value. Equally important is a clear understanding of the changing risk landscape. We launched *Zurich HelpPoint* to focus all our efforts as a global insurance group on delivering what our customers need when it matters most. Much more than a contact number or a website, it is a commitment to deliver help.

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Additionally, we can help by providing a truly global view of risk. For example, with one of our tools, the Global Risk Assessment Module, we can show how risks are interconnected around the world and how they can affect your business locally.

Finally, we can help by managing your total risk profile. With our specialists from your industry, we can identify key exposures and then help design insurance solutions to mitigate them.

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HOW MANY WAYS CAN YOU TAX THE RICH?

Democrats are scrambling to fund their wish list while keeping Obama's pledge to go easy on most Americans



House Speaker Pelosi favors a surcharge on couples making $1 million or more

BRENDAN SMIALOWSKI/REDUX/THE NEW YORK TIMES

By Ryan J. Donmoyer

Rarely have the rich been so popular with Democrats. Boxed in by President Barack Obama's campaign pledge not to raise taxes on anyone earning less than $200,000, Democrats have proposed more than a half-dozen ways to target high earners to pay for a growing list of priorities, from extending health insurance coverage to 30 million Americans to covering the cost of the troop surge in Afghanistan.

Soaking the rich may appeal to the Democratic base, but tax analysts say there isn't enough money at the high end of the income ladder to finance the Democrats' wish list without imposing confiscatory rates. About 4.5 million households filed tax returns reporting $200,000 or more of income in 2007, according to IRS data. They paid a combined $610 billion, or 44%, of all federal income taxes. "It's just not possible to get the revenue you need only from this group," says Joel Slemrod, director of the Office of Tax Policy Research at the University of Michigan.

Eventually, tax experts say, Democrats will have to relent and raise taxes on those making less than $200,000, or introduce a value-added levy on goods and services, a type of consumption tax common in Europe. "There's widespread agreement that you are going to have to adopt fiscal measures that go beyond the top 2% or 3% of the population," says Alan D. Viard, a resident scholar at the American Enterprise Institute, a Washington think tank.

There's no shortage of ideas in Washington on how to squeeze more money out of the rich. For starters, the White House intends to allow some of the tax cuts enacted under President George W. Bush to expire in 2011, which will cause the top rate on income to return to 39.6% from 35%. Capital-gains and dividend taxes will go up, too. Plus, Congress may act this month to restore a tax on large estates set to lapse next year.

Prospects for other proposals are more uncertain. Momentum behind a tax on stock and derivatives trades seems to be dissipating, while a proposed 40% levy on so-called Cadillac health plans is running into opposition from labor unions, a core Democratic constituency. But two other measures have a decent shot at eventually passing: One calls for the introduction of a 5.4% surcharge on couples with income above $1 million—favored by House Speaker Nancy Pelosi—and the other would raise Medicare payroll taxes on high earners to help fund the health-care overhaul. If those were enacted, along with the expiration of the Bush tax cuts, the top marginal rate would rise to about 55% in high-tax states—a level not seen since the pre-Reagan era, according to the Tax Foundation, a Washington-based research group.

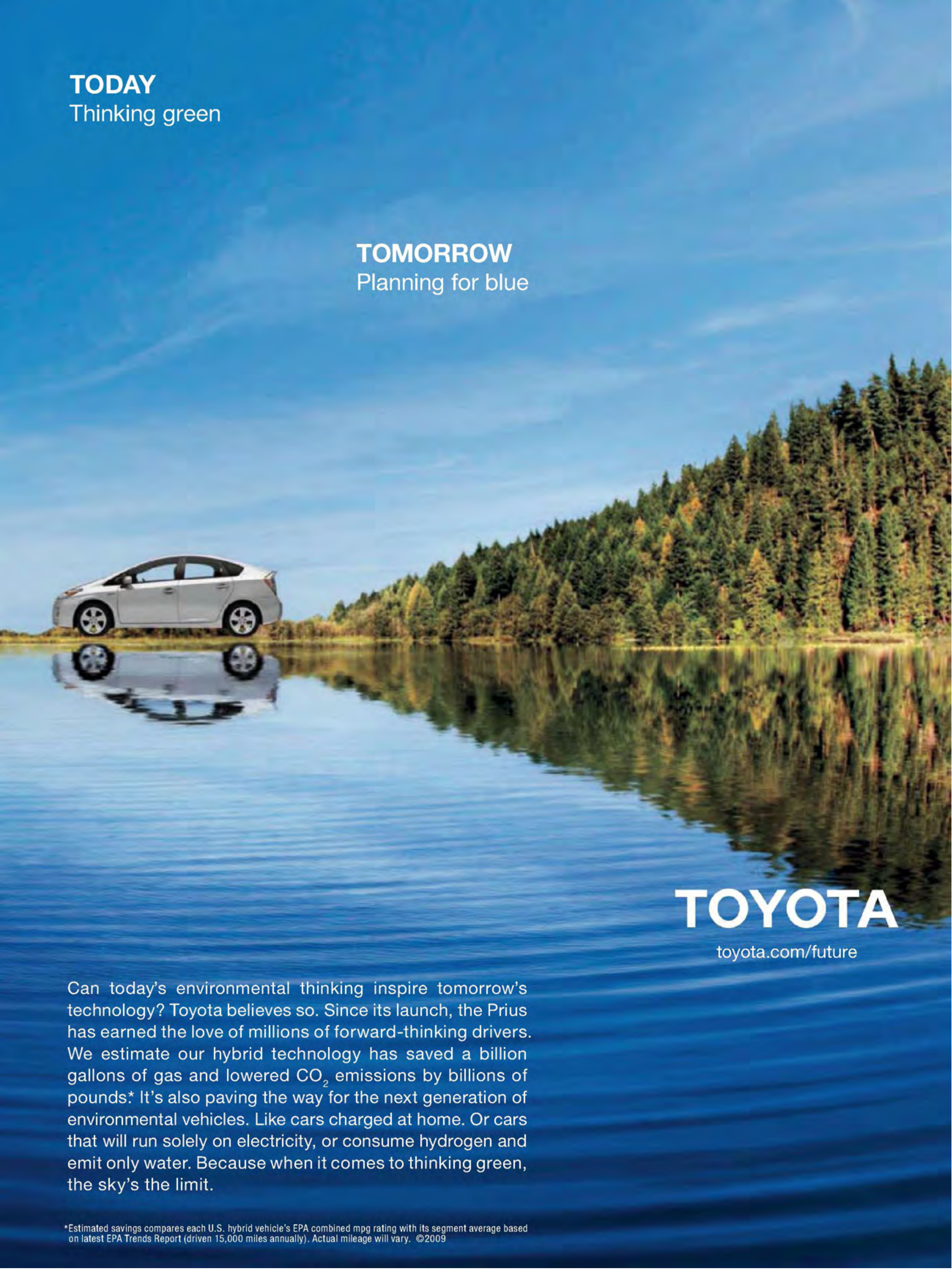
Democrats say it's only fair to ask top earners to pay more because their share of income rose while their tax burden fell disproportionately under Bush. Data released by the IRS in January showed the average tax rate paid by the richest 400 Americans fell by a quarter, to 17.2%, and their average income doubled to $263.3 million through the first six years of the Bush Administration. "They have done incredibly well," says Senator Carl Levin (D-Mich.), who is pushing for a "war tax" on wealthy households.

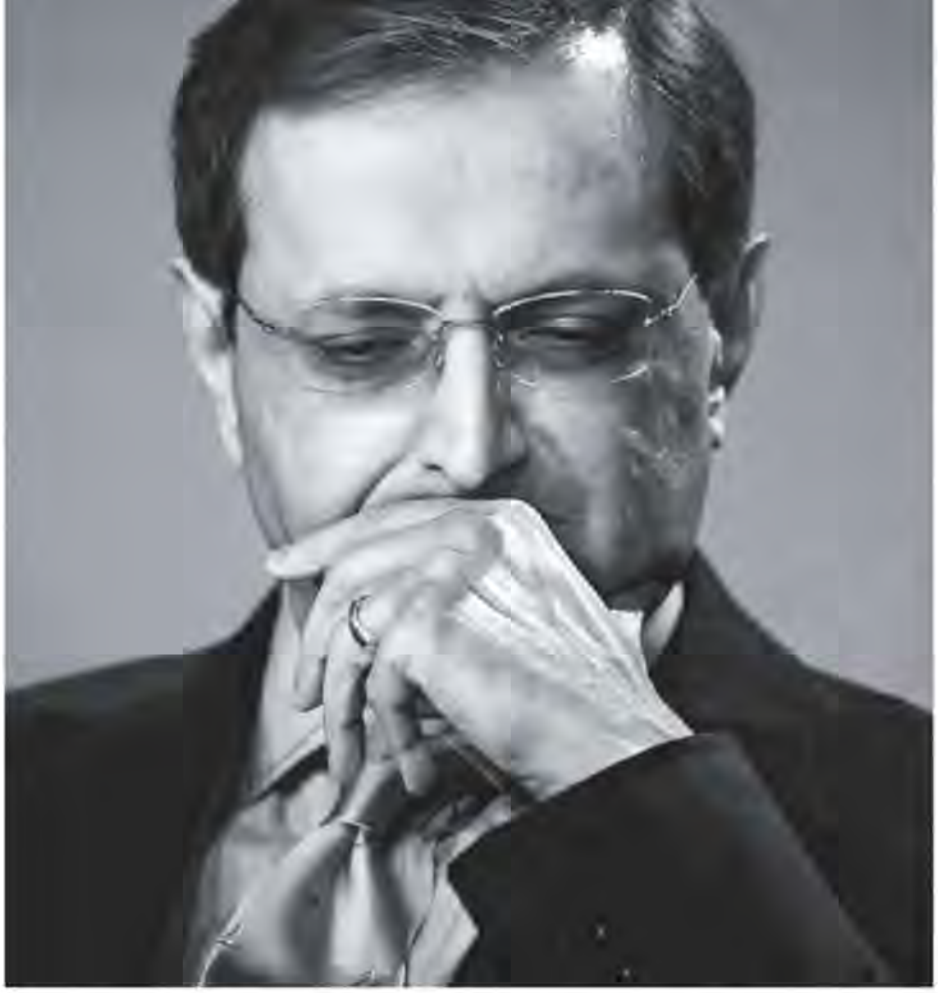
Yet the Democrats' tax strategy could also backfire by offering their rivals a political opening ahead of next year's midterm elections. Says Clint Stretch, a principal at the Washington consulting firm Deloitte Tax: Democrats "run the risk of really reinvigorating the Republican Party on an issue it's been able to succeed on." |BW|

66%

Share of respondents in a poll of 1,000 Americans who say taxes on the wealthy should be raised to reduce budget deficits

Data: Bloomberg National Poll


TODAY
Thinking green
TOMORROW
Planning for blue
TOYOTA
toyota.com/future
Can today's environmental thinking inspire tomorrow's technology? Toyota believes so. Since its launch, the Prius has earned the love of millions of forward-thinking drivers. We estimate our hybrid technology has saved a billion gallons of gas and lowered CO_2 emissions by billions of pounds.* It's also paving the way for the next generation of environmental vehicles. Like cars charged at home. Or cars that will run solely on electricity, or consume hydrogen and emit only water. Because when it comes to thinking green, the sky's the limit.
*Estimated savings compares each U.S. hybrid vehicle's EPA combined mpg rating with its segment average based on latest EPA Trends Report (driven 15,000 miles annually). Actual mileage will vary. ©2009



CEO Pandit hopes to shed Citi's TARP debt to avoid federal limits on pay

JIM WATSON/AFP/GETTY IMAGES

TARP: LAST BANK OUT IS A ROTTEN EGG

Citi, the only major bank left with "exceptional" federal aid, is racing to arrange payback terms

By Bradley Keoun and David Mildenberg

When Bank of America CEO Kenneth D. Lewis announced plans to pay back the government on Dec. 2, Citigroup CEO Vikram Pandit took the surprising news as a wake-up call. Early the next morning, several Citi executives called officials at the Treasury Dept. to discuss their options, according to a person close to the agency. They wanted to know how BofA negotiated such a quick exit from the Troubled Asset Relief Program and how Citi might follow suit.

Now Pandit is busy pressing regulators for an agreement that would allow the New York-based bank to repay its remaining $20 billion in funds from TARP. (In September the government converted $25 billion of Citi's bailout money into an equity stake in the bank.) Pandit's hoping to hash out a plan in the next week or so, say people familiar with the situation. With BofA wiring the money to Treasury on Dec. 9, Citi is the only big bank with so-called exceptional assistance. The designation, which Citi received after getting a second helping of aid, means the bank must comply with federal limits on compensation. Stuck under the government's watch, Citi risks losing top traders and bankers to rival companies dangling fatter paychecks. Citi spokesman Jon Diat declined to comment for this story.

The talks between Citigroup and its regulators could be more complex than those for Bank of America, whose lending operations are in better shape. The BofA discussions stretched over two months as regulators and executives tried to come to terms. In the case of Citi, Treasury is insisting that any exit strategy also include a formal process for selling the government's 34% equity stake in the lender, currently worth $30 billion. The parties also must address what to do with the government guarantees on $301 billion of Citi's riskiest mortgages, auto loans, commercial real estate, and other assets. Citi and BofA are "very different beasts," says Dennis Santiago, chief executive of research firm Institutional Risk Analytics.

For months, Citi hadn't made much of an effort to return the federal aid. Instead Pandit concentrated on winding down and selling businesses, as well as stockpiling cash, which has doubled over the past year to $244 billion. The bank was also battling with Treasury pay czar Kenneth Feinberg, who told Citi to cut total 2009 compensation for its 25 highest-paid people by about 70% from the previous year. In October, Pandit said he was "focused on repaying TARP as soon as possible." But it wasn't until after the BofA announcement that Citi started to make progress on talks with regulators, people close to the bank say.

If BofA's dealings are any indication, Pandit may not be able to move as fast as he hopes. The 62-year-old Lewis, who first indicated in the summer his desire to pay back the federal funds, ramped up his efforts in September around the same time he said that he would step down from the top spot at

The government now owns a 34% stake in Citi, which could complicate—and slow down—its TARP negotiations with regulators

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BofA CEO Lewis made repaying TARP money a top priority

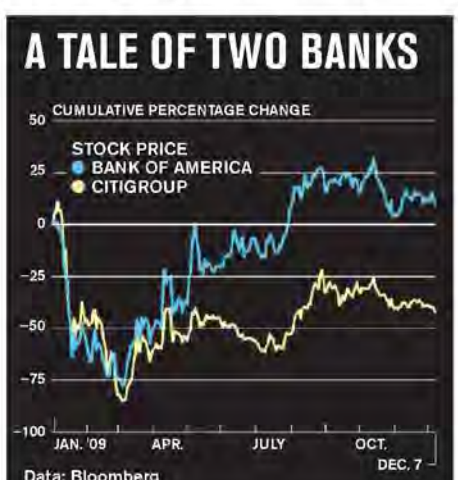
the end of the year. It helped his cause that BofA's profits had gotten a boost from the acquisition of brokerage Merrill Lynch, which accounted for a third of earnings in the first three quarters of the year. "Repaying TARP is a way for Lewis to say he did something good before he left," says Jonathan Finger, an activist investor whose family controls 1.1 million BofA shares.

After meeting with Treasury Secretary Timothy Geithner, Lewis tapped Chief Risk Officer Gregory L. Curl to head up the talks with four different government agencies. Curl "just put in a lot of personal face time working with the federal officials," says Bank of America spokesman James E. Mahoney. Regulators "turned over every possible rock to make themselves comfortable with the company." Curl, who's considered a top candidate to replace Lewis, even spent much of the Thanksgiving holiday at his Missouri farm on the phone with regulators and deferred dental surgery to get the deal done.

Similar discussions could prove tricky for Citi. For one, Pandit will have to satisfy Sheila Bair, chairman of the Federal Deposit Insurance Corp., that the bank can stand on its own. The two haven't had a cozy relationship. In April, Bair told associates that she thought Pandit should be replaced, people familiar with the matter said at the time. In July she forced Citi to reassign its chief financial officer, Edward J. Kelly III, now a vice-chairman overseeing strategy.

Bair also proved a sticking point in discussions with BofA. In October the bank proposed raising as little as $10 billion in fresh capital as part of its plan to repay $45 billion in bailout funds. Officials, including Bair, pressed for more from BofA. She pointed out that her agency guaranteed at least $21 billion of the bank's debt and much of its $899.5 billion of U.S. deposits, people familiar with the matter say. BofA eventually agreed to add more than $18.8 billion in capital and ultimately raised $19.3 billion in December.

Those terms may serve as a starting point for an eventual agreement with Citigroup, a person close to the Treasury says. Consider BofA's capital levels. In a press release on Dec. 9, BofA said that its capital by one measure stood at 11% of assets after raising new money and repaying TARP. That's down from 12.5% on Sept. 30. As of the most recent data, Citi's capital amounted to 12.8%. Says Chris Kotowski, an analyst at Oppenheimer & Co. in New York: "It's a question of how much the regulators will force banks to raise to clear themselves of the stigma of being a TARP bank."



STIGMATIZED

To plump up its cushion, Citi would have to rally investors. CreditSights analyst David Hendler estimates that the bank would need to sell about $10 billion in equity and $10 billion of other securities. The offering could be popular. At roughly $4 a share, Citi is trading at a significant discount to the assets on its books. "People will think it's a great deal," says Ralph W. Cole IV, senior vice-president at Ferguson Wellman, a Portland (Ore.) firm that manages more than $2 billion.

Unless Citi can strike a deal with regulators, the bank may struggle to compete. In investment banking, compensation is the biggest expense, and Pandit is concerned the pay caps might drive away some of his biggest producers. That's why Citi agreed to sell its Phibro oil trading subsidiary in October for $250 million, less than the unit's average annual earnings; the bank had been warned that Treasury would balk at the $100 million pay package to head trader Andrew Hall.

There's also the stigma. While investors and customers initially viewed the TARP money as a regulatory seal of approval, they now see it as a sign of weakness. With BofA exiting the bailout program, corporate clients have yet another option if they don't want to bank with a government-affiliated institution. Depositors may also factor in the distinction. "The costs of getting out of TARP are worth it," says Matt McCormick, a banking industry analyst at Bahl & Gaynor in Cincinnati. "Right now Pandit has a hand tied behind his back, and his competitors do not." |BW|

–With Ian Katz in Washington, D.C., and Michael Moore in New York

BEBETO MATTHEWS/AP PHOTO; CHART BY DAVID FOSTER/BW

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A LONG SHADOW OVER SMALL BANKS

Regional institutions are burdened by the huge bets they made on commercial property lending

By Elizabeth Hester and Linda Shen

As the nation's largest financial institutions scramble to pay back their bailout money, some regional banks may be on the government dole until at least 2011. Lending for offices, malls, hotels, and similar properties averages more than a third of loans at 35 of the biggest regional players with federal funds, according to an analysis by *Bloomberg BusinessWeek*. By comparison, such debt averages 9.5% of loans at Citigroup and Wells Fargo. And with defaults at a 16-year high and rising, the worst may be yet to come.

Unlike their bigger brethren, regional banks didn't diversify much into areas such as selling stocks and bonds. Instead, the smaller institutions—which typically operate in several communities or states, and don't have a national or international presence—found themselves lured by the potential riches of commercial real estate. "Regional banks basically became real estate banks," says Jeff Davis, an analyst at FTN Equity Capital Markets, an equity research firm. Among the group of regional banks in the analysis, seven have more than half their loans in commercial real estate, including Zions Bancorporation, headquartered in Salt Lake City, and Synovus Financial in Columbus, Ga. A spokesman for Zions says the losses will be "extremely manageable."

Now the loans are souring as vacancies rise and prices plummet. Portland (Ore.) lender Umpqua Holdings sank $3.4 million, according to local paper *Bend Bulletin*, into the Shire, a development where the artificial thatched-roof homes are modeled on the hobbit community in the *Lord of the Rings*



trilogy. The developer defaulted in July. Umpqua CEO Raymond Davis said that while the bank did not experience a "significant loss" on the Shire, its real estate portfolio was "showing signs of weakness."

Profits are suffering. Synovus, which has two-thirds of its loans in commercial property and construction, has posted five straight quarterly losses. The lender is projected to lose money for all of 2010. One of the bank's failures: a $220 million loan to Sea Island, a Georgia real estate developer that fell behind on its payments. Last month, co-lender Wells Fargo took over the deed to Sea Island's 3,000-acre Frederica community on St. Simons Island. "We let our percentages [in commercial real estate] get higher than we normally have," says Kevin Howard, Synovus' chief credit officer. "We got out of whack...trying to keep up with the herd." Another eight banks with more than 30% of their loans in commercial real estate aren't expected to show a profit next year.

Until the regional banks are on better financial footing, the government likely will have a say in their affairs. When considering whether to let banks repay the bailout funds, the U.S. is looking at profits and capital, among other things. Big banks, which have more revenue streams, may have an edge. If Citigroup and Wells Fargo join JPMorgan Chase and Bank of America in returning their bailout funds, they'll be free to press their advantage in markets they already dominate, such as consumer lending. Regional firms with federal aid may also look less attractive to investors, since those banks won't be able to declare dividends or stock repurchases without seeking the feds' approval.

It may take awhile for regional players to get out from under the government. Unpaid commercial real estate loans, which stood at 3.4% in the third quarter, may reach 5.3% in two years, estimates Real Estate Econometrics, a property research firm in New York. "The commercial real estate problem is looming," says William Bartmann, CEO of Bartmann Enterprises, a debt advisory firm. "We can see that it's coming. It just hasn't shown up yet." |BW|

37%

The average share of loans that 35 of the largest regional banks with bailout funds have in commercial real estate, vs. less than 10% for some big players.

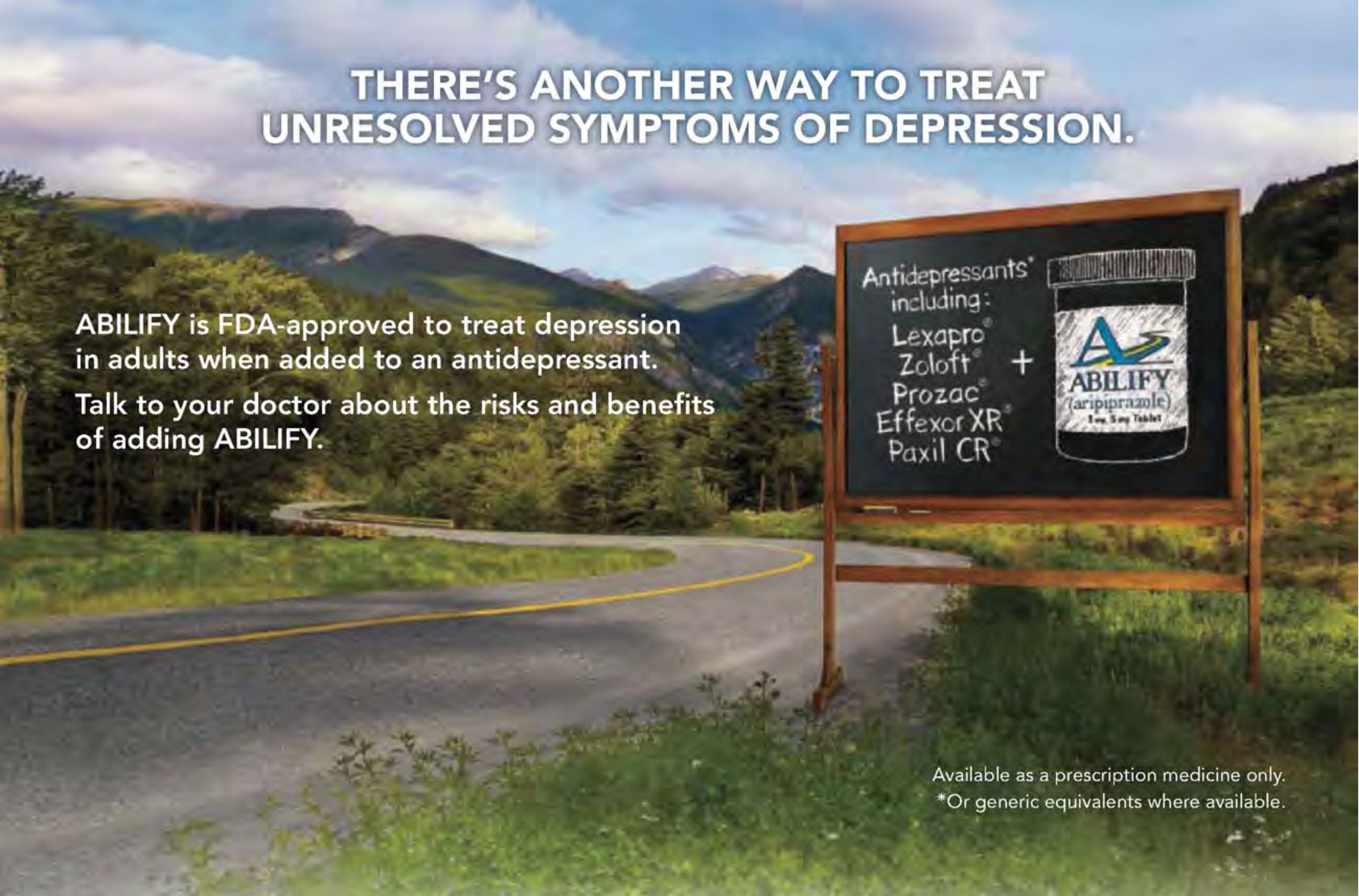
Data: Bloomberg

THOMAS FUCHS

THERE'S ANOTHER WAY TO TREAT UNRESOLVED SYMPTOMS OF DEPRESSION.

ABILIFY is FDA-approved to treat depression in adults when added to an antidepressant.

Talk to your doctor about the risks and benefits of adding ABILIFY.



Available as a prescription medicine only.
*Or generic equivalents where available.

IMPORTANT SAFETY INFORMATION:

Elderly patients with dementia-related psychosis (eg, an inability to perform daily activities due to increased memory loss) taking ABILIFY have an increased risk of death or stroke. ABILIFY is not approved for treating these patients.

Antidepressants can increase suicidal thoughts and behaviors in children, teens, and young adults. Serious mental illnesses are themselves associated with an increase in the risk of suicide. When taking ABILIFY call your doctor right away if you have new or worsening depression symptoms, unusual changes in behavior, or thoughts of suicide. Patients and their caregivers should be especially observant within the first few months of treatment or after a change in dose. Approved only for adults 18 and over with depression.

- Call your doctor if you develop very high fever, rigid muscles, shaking, confusion, sweating, or increased heart rate and blood pressure, as these may be signs of a rare but potentially fatal condition called **neuroleptic malignant syndrome (NMS)**
- If you develop abnormal or uncontrollable facial movements, tell your doctor, as these may be signs of **tardive dyskinesia (TD)**, which could become permanent
- If you have **diabetes** or have risk factors or symptoms of diabetes, your blood sugar should be monitored. High blood sugar has been reported with ABILIFY and medicines like it. In some cases, extreme high blood sugar can lead to coma or death
- **Other risks** may include lightheadedness upon standing, decreases in white blood cells (which can be serious), seizures, trouble swallowing, or impairment in judgment or motor skills. Until you know how ABILIFY affects you, you should not drive or operate machinery

The **common side effects** in adults in clinical trials (≥10%) include nausea, vomiting, constipation, headache, dizziness, an inner sense of restlessness or need to move (akathisia), anxiety, and insomnia. Tell your doctor about all the medicines you're taking, since there are some risks for drug interactions. You should avoid alcohol while taking ABILIFY.

You are encouraged to report negative side effects of prescription drugs to the FDA. Visit www.fda.gov/medwatch, or call 1-800-FDA-1088.

Please read the additional Important Information about ABILIFY on the adjacent page.

*Lexapro® (escitalopram oxalate), Zoloft® (sertraline HCl), Prozac® (fluoxetine hydrochloride), Effexor XR® (venlafaxine HCl), Paxil CR® (paroxetine HCl) are trademarks of their respective companies.

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ABILIFY (aripiprazole) 2, 5, 10, 15, 20, 30 mg Tablets

IMPORTANT INFORMATION ABOUT ABILIFY

This summary of the Package Insert contains risk and safety information for patients about ABILIFY. This summary does not include all information about ABILIFY and is not meant to take the place of discussions with your healthcare professional about your treatment. Please read this important information carefully before you start taking ABILIFY and discuss any questions about ABILIFY with your healthcare professional.

Name

ABILIFY® (a-BIL-i-fi) (aripiprazole) (air-i-PIP-ra-zoll)

What is ABILIFY?

ABILIFY (aripiprazole) is a prescription medicine used as an add-on treatment to antidepressants for Major Depressive Disorder in adults.

What is depression?

Depression is a common but serious medical condition. Symptoms may include sadness, loss of interest in activities you once enjoyed, loss of energy, difficulty concentrating or making decisions, feelings of worthlessness or excessive guilt, insomnia or excessive sleep, a change in appetite causing weight loss or gain, or thoughts of death or suicide. These could be depression symptoms if they interfere with daily life at home, at work, or with friends and last most of the day, nearly every day for at least 2 weeks.

What is the most important information that I should know about antidepressant medicines, depression, and other serious mental illnesses?

- Antidepressant medicines may increase suicidal thoughts or actions in some children, teenagers, and young adults
- Depression and serious mental illnesses are the most important causes of suicidal thoughts and actions

For more information, see the Prescribing Information and the Medication Guide called *Antidepressant Medicines, Depression and Other Serious Mental Illnesses, and Suicidal Thoughts or Actions.*

Who should NOT take ABILIFY?

People who are allergic to ABILIFY or to any substance that is in it. Allergic reactions have ranged from rash, hives and itching to difficulty breathing and swelling of the face, lips, or tongue. Please talk with your healthcare professional.

What is the most important information that I should know about ABILIFY?

Elderly patients, diagnosed with psychosis as a result of dementia (for example, an inability to perform daily activities as a result of increased memory loss), and who are treated with antipsychotic medicines including ABILIFY, are at an increased risk of death when compared to patients who are treated with a placebo (sugar pill). ABILIFY is not approved for the treatment of patients with dementia-related psychosis.

Antidepressants may increase suicidal thoughts or behaviors in some children, teenagers, and young adults, especially within the first few months of treatment or when the dose is changed. Depression and other serious mental illnesses are themselves associated with an increase in the risk of suicide. Patients on antidepressants and their families or caregivers should watch for new or worsening depression symptoms, unusual changes in behavior, or thoughts of suicide. Such symptoms should be reported to the patient's healthcare professional right away, especially if they are severe or occur suddenly. ABILIFY is not approved for use in pediatric patients with depression.

Serious side effects can occur with any antipsychotic medicine, including ABILIFY. Tell your healthcare professional right away if you have any conditions or side effects, including the following:

Stroke or ministroke in elderly patients with dementia: An increased risk of stroke and ministroke has been reported in clinical studies of elderly patients with dementia (for example, increased memory loss and inability to perform daily activities). ABILIFY (aripiprazole) is not approved for treating patients with dementia.

Neuroleptic malignant syndrome (NMS): Very high fever, rigid muscles, shaking, confusion, sweating, or increased heart rate and blood pressure **may be signs of NMS, a rare but serious side effect that could be fatal.**

Tardive dyskinesia (TD): Abnormal or uncontrollable movements of face, tongue, or other parts of body may be signs of a serious condition known as TD, which may be permanent.

High blood sugar and diabetes: Patients with diabetes and those having risk factors for diabetes (for example, obesity, family history of diabetes), as well as those with symptoms such as unexpected increases in thirst, urination, or hunger should have their blood sugar levels checked before and during treatment. Increases in blood sugar levels (hyperglycemia), in some cases serious and associated with coma or death, have been reported in patients taking ABILIFY, and medicines like it.

Orthostatic hypotension: Lightheadedness or faintness caused by a sudden change in heart rate and blood pressure when rising too quickly from a sitting or lying position (orthostatic hypotension) has been reported with ABILIFY.

Leukopenia, Neutropenia, and Agranulocytosis: Decreases in white blood cells (infection fighting cells) have been reported in some patients taking antipsychotic agents, including ABILIFY. Patients with a history of a significant decrease in white blood cell (WBC) count or who have experienced a low WBC due to drug therapy should have their blood tested and monitored during the first few months of therapy.

Suicidal thoughts: If you have suicidal thoughts, you should tell your healthcare professional right away.

Dysphagia: Medicines like ABILIFY have been associated with swallowing problems (dysphagia). If you had or have swallowing problems, you should tell your healthcare professional.

What should I talk to my healthcare provider about?

Patients and their families or caregivers should watch for new or worsening depression symptoms, unusual changes in behavior and thoughts of suicide, as well as for anxiety, agitation, panic attacks, difficulty sleeping, irritability, hostility, aggressiveness, impulsivity, restlessness, or extreme hyperactivity. Call your healthcare provider right away if you have thoughts of suicide or if any of these symptoms are severe or occur suddenly. Be especially observant within the first few months of antidepressant treatment or whenever there is a change in dose.

Tell your healthcare provider about any medical conditions you may have and all medicines that you are taking or plan to take, including prescription and over-the-counter medicines, vitamins, or herbal products.

Be sure to tell your healthcare provider:

- If you have suicidal thoughts
- If you have or have had a low white blood cell count (WBC)
- If you or anyone in your family have or had seizures
- If you or anyone in your family have or had high blood sugar or diabetes
- If you are pregnant, plan to become pregnant, or are breast-feeding

What should I avoid when taking ABILIFY?

- Avoid overheating and dehydration
- Avoid driving or operating hazardous machinery until you know how ABILIFY affects you
- Avoid drinking alcohol
- Avoid breast-feeding an infant

What are the possible side effects of ABILIFY (aripiprazole)?

Common side effects in adults include: nausea, vomiting, constipation, headache, dizziness, an inner sense of restlessness or need to move (akathisia), anxiety and insomnia.

It is important to contact your healthcare professional if you experience prolonged, abnormal muscle spasm or contraction which may be signs of a condition called dystonia.

This is not a complete list of side effects. For full patient information, visit www.abilify.com. Talk to your healthcare professional if you have questions or develop any side effects.

What percentage of people stopped taking ABILIFY due to side effects?

In clinical trials, the percentage of adults who discontinued taking ABILIFY due to side effects was 6% and 2% for patients treated with sugar pill.

Can I safely take ABILIFY while I'm taking other medications?

ABILIFY can be taken with most drugs; however, taking ABILIFY with some medicines may require your healthcare professional to adjust the dosage of ABILIFY.

Some medicines* include:

- ketoconazole (NIZORAL®)
- quinidine (QUINIDEX®)
- fluoxetine (PROZAC®)
- paroxetine (PAXIL®)
- carbamazepine (TEGRETOL®)

It is important to tell your healthcare professional about all the medicines you're taking, just to be sure.

How should I take ABILIFY?

- Take ABILIFY exactly as directed by your healthcare professional
- ABILIFY is usually taken once a day and can be taken with or without food
- If you miss a dose, take it as soon as you remember. However, if it is time for your next dose, skip the missed dose and take only your regularly scheduled dose
- Talk to your healthcare professional before stopping ABILIFY or changing your dose

General advice about ABILIFY:

- ABILIFY should be kept out of the reach of children and pets
- Store ABILIFY Tablets and the Oral Solution at room temperature
- For patients who must limit their sugar intake, be aware that **ABILIFY Oral Solution contains sugar**
- For patients who cannot metabolize phenylalanine (those with phenylketonuria or PKU), **ABILIFY DISCMELT® contains phenylalanine**
- If you have additional questions, talk to your healthcare professional

Find out more about ABILIFY:

Additional information can be found at **www.abilify.com**

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BE CAREFUL WHAT YOU WISH FOR

GM finally has an activist board. But its private equity directors are making executives squirm

By David Welch and Jeff Green

For years, General Motors had one of the least assertive boards in business. And for years, critics carped that GM needed directors with the juice to force a hidebound executive suite to ditch failed strategies and remake GM into a 21st Century auto company.

Now GM has what may well be the most activist board ever. And its three most outspoken directors are private equity guys: Daniel F. Akerson, David Bonderman, and Stephen J. Girsky. Given private equity's disastrous forays at Chrysler and other companies, their presence on the board is controversial, both inside and outside GM. More broadly, governance experts worry the new board is overreaching. "There are extremes, boards that stay completely out and those that micromanage," says Charles Elson, director of the John L. Weinberg Center for Corporate Governance at the University of Delaware. "Both are dangerous."

How did GM wind up with private equity guys as directors? The Obama Administration wanted a hands-on board. And two powerful members of the federal auto task force, Steve Rattner and Harry J. Wilson, hailed from the private equity world.

A former task force member says Bonderman, 67, was chosen for his keen dealmaking skills and his managerial toughness. In 2002 he negotiated down the purchase price of Burger King by about a third, to $1.5 billion, as his firm Texas Pacific Group, now TPG, and partners took control. Akerson, this person says, was selected for his operational abilities. A managing partner at Carlyle Group, Akerson, now 61, ran MCI in the early '90s.

The United Auto Workers, which owns 17.5% of GM and had the right to pick one director, chose Girsky, a former Wall Street analyst who had previously advised both GM and the union. Girsky, 47, worked for private-equity shop Centerbridge Partners and now has his own consultancy. He long criticized the previous GM management for money-losing investments in such automakers as Fiat, Isuzu, and Fuji Heavy Industries, which makes Subaru.

GM insiders complain that the trio has already brought to bear the private equity obsession with cost cutting at a company that badly needs to deploy its government-financed cash hoard to develop new cars and technology. At the September board meeting, GM executives asked the company's directors for $1 billion to fund a new engine program, which they saw as a routine investment.

The board batted the proposal back, say three people familiar with the meeting. Directors wanted to know how the company would get a return on the investment. "Unless you're in aircraft or some other big industry, this might be the first time you've seen this kind of expense," says a GM executive. Management responded that car companies need new engines to boost fuel economy and meet regulations. They don't calculate what they'll get from the money.

One of the three private equity directors asked if GM could buy an engine from someone else, say two people with knowledge of the meeting. So management had to go back, gin up a business case, and get approval. It took three meetings and two months, though the board did allow engineering work to continue during deliberations. The process cost GM precious time, says one executive familiar with the debate, and it demonstrated that management and the new board think about things very differently.

Akerson, Bonderman, and Girsky declined to comment. But Patricia F. Russo, the former CEO of Alcatel-Lucent, who became a GM director in July, says the debates between the board and management have been healthy. "This board understands the difference between running the day-to-day business and giving good governance and oversight," she says.

GM executives are being held accountable for the first time in years. It will be interim CEO Edward E. Whitacre Jr.'s job to play referee between the board and his new management team. |BW|

POWER TRIO



BONDERMAN
The founder of buyout shop TPG was chosen for his dealmaking prowess and toughness deemed key in a turnaround



GIRSKY
An ex-Wall Street analyst and private equity guy who long criticized GM management, he has emerged as Whitacre's go-to adviser



AKERSON
The Carlyle Group partner was selected for his years of operational experience, most notably running telecom titan MCI

(BONDERMAN) ANTOINE ANTONIOL/BLOOMBERG NEWS

GREECE RATTLES THE EURO ZONE

Athens' budget deficits are damaging its credit rating and will test the solidity of the EU's monetary union

By Peter Coy

As the global financial crisis rocks Greece, Europe faces a question as basic as they come: What do you do when a one-size-fits-all currency no longer fits all? On Dec. 8, Fitch Ratings downgraded Greek government debt, based on new estimates that the country's budget deficit was out of control. The rating revision spooked Europe's markets as investors fretted that Athens might soon default on its bonds.

Greece and other European countries that use the euro lack the options the U.S. has in fighting a recession. To combat sinking demand, Washington can run huge budget deficits while cutting interest rates to near zero and allowing the dollar to depreciate. Under EU rules, Greece's deficit isn't supposed to top 3% of gross domestic product (though it has almost always done so, and the level today is 12.7% of GDP). And it can't devalue its currency to ramp up exports because it gave up the drachma for the euro in 2001.

The strains on the euro zone are emboldening those who question whether it makes sense to lock such disparate nations into a single monetary policy. "The current situation in Greece shows the problems created by a single currency," says Martin Feldstein, a Harvard University economist who is perhaps the euro's most prominent skeptic. For much of the past five years, the European Central Bank pursued a relatively loose monetary policy to keep France, Germany, and other large northern economies growing. But the likes of Spain, Ireland, and Greece needed tighter policy to keep from overheating. "The single currency enabled Greece to issue enormous amounts of government debt ... until it reached the current crisis level," Feldstein said in an e-mail interview.



To boost investor confidence, Papandreou must cut government spending sharply

PETROS KARADJIAS/AP PHOTO

With billions of euros in government debt due next spring, "it's five minutes to midnight for Greece," says one expert

THE EU'S QUANDARY

Fitch cut Greece's rating to BBB+. That's a problem because the European Central Bank isn't supposed to accept sovereign debt as collateral for loans to commercial banks unless the debt is rated A- or higher. Although those rules have been relaxed during the financial crisis, they're slated to go back into effect in 2011. If the ECB doesn't make an exception for Greece, Greek banks that hold lots of bonds issued by Athens will be cut off from an important source of funds.

Europe is in a quandary over how to cope with Greece's crisis. Sticking to the budgetary rules could deepen the pain for ordinary Greeks. But not enforcing the regulations will make the EU look like a pushover and invite weaklings such as Spain, Italy, and Ireland to demand similar treatment—which would increase the risk of inflation across Europe and undermine the integrity of the euro.

Although the single currency is likely to make it through this crisis, it could face an even bigger one next spring when billions of euros in Greek government debt must be refinanced. Athens is already paying more to borrow because of the perceived risk, and now Standard & Poor's is also reviewing Greece's credit rating. "It's five minutes to midnight for Greece," former Bank of England policymaker Willem H. Buiter said in a Bloomberg Television interview.

To win back the confidence of investors, Greek Prime Minister George Papandreou will have to jettison campaign promises he made in the runup to October elections. He had pledged to increase state-sector salaries faster than inflation and boost stimulus spending. Now he'll be forced to rein in government outlays dramatically since the European Union fears the precedent a bailout would set, says Lena Komileva, an economist at brokerage Tullett Prebon in London. Spending cuts will hurt, but in the long run they will be better than a default, which would drive up Greek interest rates for years. Even worse, though, would be an exit from the monetary union. "That," says Komileva, "is too painful to contemplate." |BW|

—With Natalie Weeks and Maria Petrakis

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HANDLING A WOUNDED TIGER

Big brands are sticking with him, but the public may never again look at Woods the same way



Burning less bright: Pepsi recently killed the Tiger Woods Gatorade flavor

DAVID CANNON/GETTY IMAGES

By Burt Helm

Imagine you are a marketing executive locked in a long-term endorsement deal with Tiger Woods. You keep telling the world that you stand behind your man despite the mysterious SUV crash and swirl of innuendo about his married life. But as reports of alleged infidelity keep surfacing, the question becomes ever more insistent: "Is Tiger really still your pitchman?" In most cases, marketing veterans think the long-term answer is yes.

The celebrity endorser scandal plays out predictably. When the tabloid coverage is at its most feverish, sponsors "go dark," pulling ads off the airwaves. (Nearly all Woods sponsors did this.) After a few weeks, the public gets bored. The obsession with Tiger may return when he gets back to the links—and could spike TV ratings for tournaments he plays in. By then, non-golf fans will have tuned into the next scandal. "It's gonna be a blip," says Larry Novenstern, who buys TV ads for media agency Optimedia.

Behind the scenes, though, Nike, Gatorade, AT&T, Accenture, Tag Heuer, Gillette, and other Woods sponsors are likely aware that Tiger will never command the kind of public admiration he did at his peak.

For 13 years, Woods has been a dream spokesperson. His precise golf game exuded reliability and quality, while his biography—doting Army vet father, Thai mother—gave him an almost Obama-like global appeal. At the same time, Woods was wonderfully dull; he didn't distract consumers from the products. Altogether, these qualities earned him $100 million annually.

For sponsors targeting golf fans, the question now is: If not Tiger, then who? The answer is probably "nobody"

And Woods is not simply an endorser. In several cases, he practically is the product. Tiger Woods is a Gatorade flavor—or he was until Pepsi killed the drink, saying it had decided to eliminate the flavor months before. Woods is the "developer" of a style of Tag Heuer watch. Sports marketing guys will tell you he's the reason Nike has any market share at all in the golf equipment market. "Some of these companies are so heavily invested in Tiger that they would have to completely reverse course and suffer an erosion in business if they cut ties with him," says Phil de Picciotto, president of sports marketing agency Octagon.

But Woods' reputation, like that of other celebrities, will never completely recover. Millward Brown, a branding agency, recently began tracking public perception of celebrities. Other stars have struggled to shake bad press. When Serena Williams cursed at a line judge during a U.S. Open match in September, the number of people with a negative impression of her jumped from 4% to 45%. As of Dec. 4, 40% still thought of her negatively. After rapper Kanye West wrested a trophy from the hands of country music star Taylor Swift at the MTV Video Music Awards in September, his negatives spiked from 17% to 81%. Today, that number hovers around 68%. And how has Woods fared in the Millward Brown study so far? Just 2% of people surveyed had a negative impression of him pre-crash. In early December, 80% did.

As marketing execs eye the morals clauses and end dates in Woods' contract for possible outs, the discussion may soon hinge on one question: If not Tiger, then who? For sponsors targeting golf fans, the answer is probably "nobody." It's telling that both companies that have publicly voiced support for Woods are sports brands—Gatorade and Nike. Non-sports brands, like Accenture and AT&T, don't need a golfer. As *Bloomberg BusinessWeek* went to press, neither had commented—or made any public show of support. |BW|

—With Brett Pulley


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Kravis has entirely rethought the playbook, wanting "more control over our destiny"

OMAHA ON THE HUDSON

Henry Kravis and George Roberts have a new, long-term vision for KKR: Make the granddaddy of private equity firms more like Buffett's Berkshire Hathaway. Can the buyout kings pull it off?

By Emily Thornton

Photograph by Thomas Broening

It's difficult to believe that Henry Kravis could suffer from portfolio envy. The private equity titan and co-founder of Kohlberg Kravis Roberts is famous for his ability to buy and sell companies for profit. It's a skill that has made him enormously wealthy over his 33 years at KKR's helm: Kravis, 65, is worth an estimated $3.8 billion, according to *Forbes*. His firm owns or holds stakes in 51 companies with combined annual revenues of $218 billion—more than double that of private equity rivals Blackstone and the Carlyle Group. Among KKR's big-name holdings: retailer Toys "R" Us, research firm Nielsen, and hospital giant HCA. ¶ Yet as he sits in his sparsely decorated office overlooking the south end of New York's Central Park, Kravis' thoughts drift west, to Omaha, the home of financial conglomerate Berkshire Hathaway. "He can make any kind of investment he wants," Kravis says of Berkshire CEO Warren Buffett, the object of his admiration. "And he never has to raise money." Kravis thinks Berkshire, with its piles of cash and trove of publicly traded shares with which to make acquisitions, is nothing less than "the perfect private equity model."

What Kravis and co-founder George Roberts, 66, covet most is Buffett's ability to pounce on deals of all sizes in any economic environment. "He has certain advantages over us," says Kravis. "I would like to see us create those advantages for ourselves."

That the storied dealmakers at KKR are acknowledging their shortcomings says much about the state of the leveraged buyout business. There was a time when private equity firms could easily collect money from investors, borrow more from banks, use the cash to buy companies, rejigger their finances, and then sell or take them public for a quick profit. When banks stopped lending in 2007 the dealmaking ground to a halt, and firms were left holding a slew of overleveraged companies they couldn't unload. All told, 543 private-equity-owned companies in the U.S. have gone bankrupt in the past two years, according to Capital IQ—including two of KKR's: real estate lender Capmark Financial Group and doormaker Masonite. As a result, KKR's returns have suffered (chart).

Kravis and Roberts could try to wait out the rough patch, nursing their wounds and promising investors they'll do

better once the deal environment improves. Instead they're reshaping KKR's three-decade-old playbook. The financial crisis has taught the granddaddies of private equity many things. They must be nimbler and quicker. They must move beyond the audacious leveraged buyouts that have come to define private equity in the popular imagination—most famously, their 1989 acquisition of RJR Nabisco. They can't rely solely on debt to pay for their deals. They need, as Kravis puts it, "more control over our destiny."

The two have cooked up a four-part plan to make it happen. First, they're building an in-house investment bank to serve KKR's portfolio companies. Second, they're taking KKR public, with shares expected to be on the New York Stock Exchange in early 2010, in hopes of one day using the newly minted stock to make acquisitions and invest in the firm. (It listed 30% of KKR in Amsterdam in October.) Third, while Kravis and Roberts certainly aren't abandoning buyouts, they're placing more emphasis on minority stakes and joint ventures with companies in a broader array of sectors. Finally, they're adopting new management techniques to preserve KKR's tight-knit culture as the company expands.

Other private equity firms see the value in KKR's emulating Buffett. "This makes sense for them," says John Canning, chairman of buyout shop Madison Dearborn Partners. "A firm that big can't rely [solely] on historical methods of capital raising anymore. Things change." If Kravis and Roberts get this experiment right, their strategy could point the way for other buyout firms. Even bankers acknowledge the need for firms to move beyond leveraged deals. "Private equity will become broader and broader," predicts Morgan Stanley CEO John J. Mack. "Instead of buying companies and restructuring them, they will have a whole panoply of investments."

Of course, KKR isn't alone among buyout shops in wanting to tap the public markets. Blackstone and Fortress Investment Group got a head start, selling shares in 2007. But the financial crisis was cruel to their stocks: Even after a recent rally, they're down 57% and 79%, respectively, since their debuts.

KKR, in contrast, is going public at a time when the markets are on the mend. Call it patience or dumb luck, either way it could pay off. Since bottoming in March, Blackstone shares are up 245%, while Fortress' stock has jumped 272%. "These stocks were decidedly out of favor," says Michael Holland, chairman of Holland & Co., a New York investment firm. "But smart money that went in over the last several months has done very well."

ANSWERING TO MANY

Kravis is the first to say KKR will never become Berkshire East. After all, Berkshire's source of strength is its 32-year-old insurance business, which boasts an estimated $110 billion in assets, something KKR can't easily whip up for itself. What's more,







Buffett built Berkshire over many decades using equity, not just debt, to buy companies. Kravis is just now venturing down that path.

There are more immediate challenges. Once KKR goes public, it will face intense scrutiny from many quarters. "Going public makes the firm accountable to many groups—the SEC, stockholders, and the exchanges," warns Edwin Burton, a trustee for the Virginia Retirement System. Adds Charles R. Schwab, founder and chairman of Charles Schwab Corp. and a longtime friend of Roberts: "I told George to think long and hard about jumping into the fish bowl."

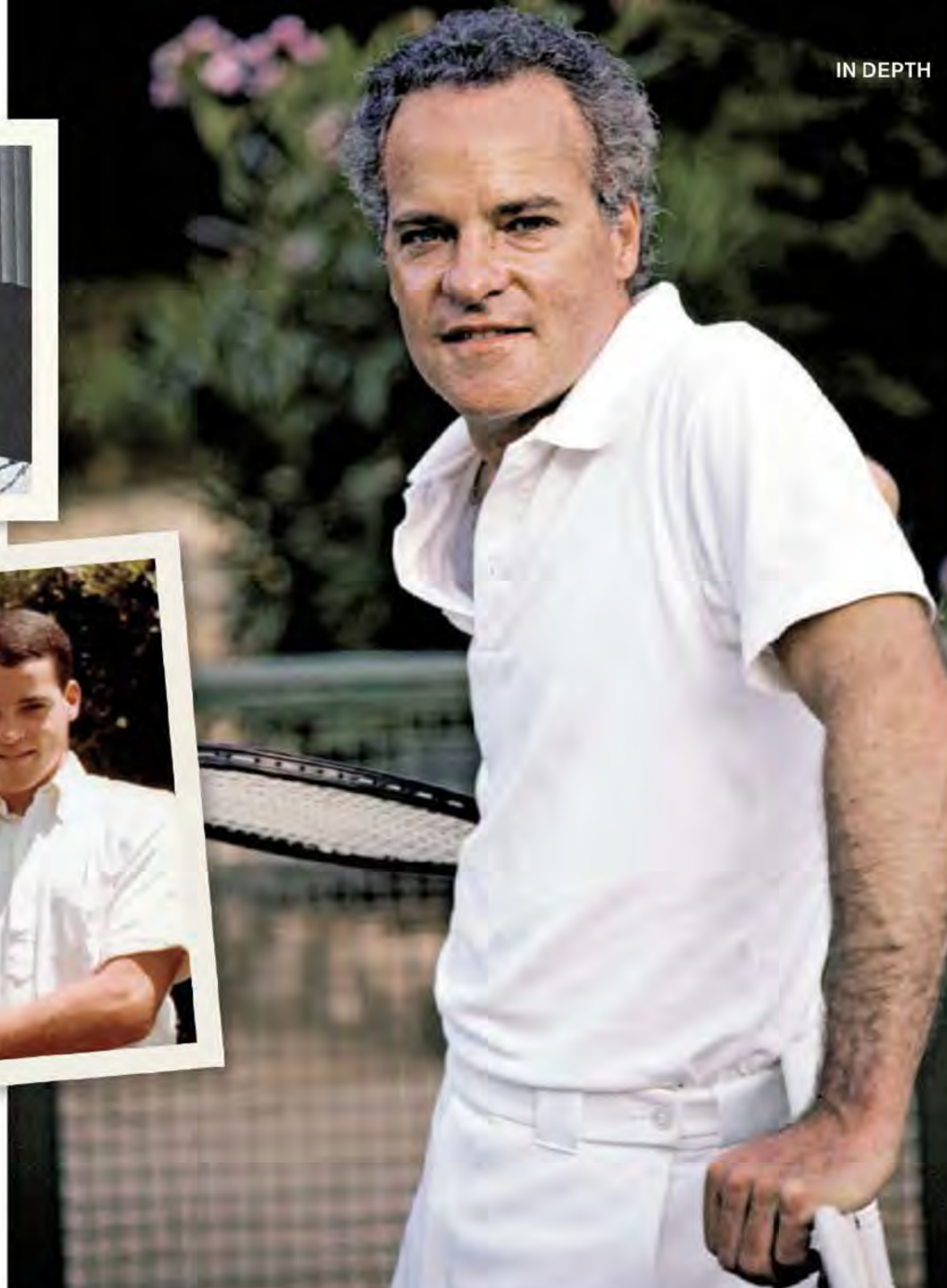
As KKR polishes its investor-relations skills it must be careful not to alienate the pension funds, university endowments, and other wealthy investors who put money directly into KKR's buyout funds and are increasingly sensitive to fees (How To Play It, page 78). They pay KKR a hefty management fee of 1.5% or more of their assets and 20% of the profits. For that they expect the firm to concentrate on selling companies—not on branching out into new businesses. "We're trying to take a long, hard look at fees across the board and make sure they're justified," says Jay Fewel, a senior investment officer at the Oregon State Treasury, one of KKR's investors.

KKR MUST AVOID ALIENATING INVESTORS WHO EXPECT THE FIRM TO FOCUS ON HUGE RETURNS—NOT BRANCH OUT INTO NEW BUSINESSES

There's also a danger that, as KKR expands, Kravis and Roberts could lose focus on its main business. "The more you scale an organization, the less impact key individuals have on investment







Clockwise from left: Roberts in 1979; Kohlberg and Kravis in 1978; Kravis in 1986; Roberts and Kravis as fellow students at Claremont McKenna College in Southern California.

(FAR RIGHT) PHOTOGRAPH BY SLIM AARONS/HULTON ARCHIVE/GETTY IMAGES

decisions," says Jeff Ennis, president of private markets at Wilshire Associates. Already there's reason for concern. Fitch Ratings issued a report in October warning that six companies in which KKR has invested—Energy Future Holdings, HCA, First Data, Toys "R" Us, Nielsen, and Sungard Data Systems—could soon face trouble repaying their debt, though Kravis says the worries are overblown.

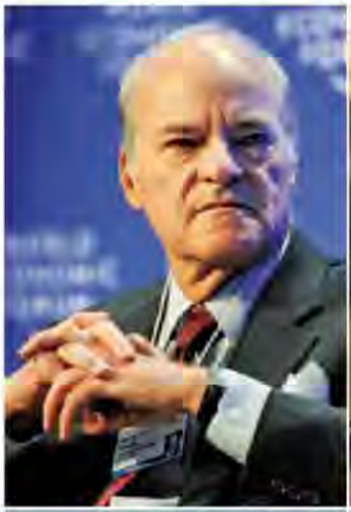
LBO VETS

On a dreary Wednesday in October at KKR headquarters in New York, Kravis, in a crisp white shirt and blue tie, is leading a meeting of KKR's portfolio management committee, with Roberts joining by videoconference from KKR's Menlo Park (Calif.) office. Their close relationship has been a key to KKR's success over the years. The cousins played together as kids and studied at the same college, Claremont McKenna in Southern California. After going their separate ways for graduate school they reconnected at Bear Stearns, where they worked on some of Wall Street's first leveraged buyouts. In 1976 both left Bear to form KKR with colleague Jerome Kohlberg. (He quit KKR in 1987 at age 61.) Decades of mind-melding have left Kravis and Roberts able to finish each other's sentences, a feat they perform often. When Roberts visits KKR's New York headquarters, he dips into the stash of Toblerone chocolate, jelly beans, and caramel Nips in the top drawer of Kravis' desk. Kravis says the last time the two disagreed with each other was when they fought over a bicycle—in 1951.

But Kravis and Roberts don't dominate KKR's internal operations as they once did. While the two say they have no intention of retiring soon, they're handing more authority to the firm's other senior executives. During the portfolio committee meeting, the people with the most questions aren't Kravis

DEALS OF THE DECADE

KKR and Berkshire Hathaway's biggest transactions




KKR			BERKSHIRE HATHAWAY		
YEAR	COMPANY NAME	PRICE	YEAR	COMPANY NAME	PRICE
2007*	TXU**	$44 billion	2009	Burlington Northern Santa Fe (77%)	$36 billion
2006*	HCA	$33 billion	2006	PacifiCorp	$9 billion
2007	First Data	$28 billion	2000	MidAmerican Energy Holdings	$8.4 billion
2007	Alliance Boots (85%)	$21 billion	2008	Marmon Holdings (60%)	$4 billion
2006*	TDC A/S (88%)	$14 billion	2006	Iscar Metalworking Cos. (80%)	$4 billion

*Includes "club" deals made with other firms **Renamed Energy Future Holdings
Data: Dealogic

or Roberts but members of KKR's senior adviser group—21 current and former corporate executives whom KKR pays to dispense wisdom on matters of strategy, investing, and management. Among them: former CEOs George M. C. Fisher of Eastman Kodak, Lee Raymond of ExxonMobil, and Joe Forehand of Accenture.

Even the look of the place has changed. A few years ago, Kravis and Roberts ditched KKR's collection of classic 19th century English paintings and early 20th century American art and replaced them with abstract modern pieces. Huge, black tribal masks now dominate the New York headquarters, while bold fluorescent light fixtures stand out in Menlo Park. "At first, a lot of people hated it," Roberts says.

Kravis and Roberts say they hoped the visual stimulation would inspire their staff to think creatively. Rivals like Blackstone and Carlyle were racing ahead in building out new businesses such as hedge funds and venture funds, and were planting flags around the globe. KKR wanted its troops to dream up ways it could diversify.

KKR's makeover began in 2006 when Kravis, Roberts, and partner Scott C. Nuttall decided to act on one of those new ideas: to create an in-house financial services operation. Wall Street investment banks were beginning to launch private equity funds, but no big buyout firm had tried to provide its own financing. KKR recruited Craig J. Farr, a managing director in the capital markets at Citigroup, to build the group. Farr's job was to establish a business from scratch that could secure financing for buyouts, refinance companies while they were in KKR's possession, and then help take those companies public when KKR was ready to sell. He didn't seek to have it join Goldman Sachs and Morgan Stanley among the world's full-fledged investment banks. Instead, his goal was merely to serve the companies KKR controlled so it could get better terms on loans and keep some of the fees it was paying to bankers.

The idea wasn't an easy sell among KKR's dealmakers, who had strong relationships with big banks. Farr says he would get calls from Goldman about KKR deals he wasn't aware of. He had to convince his colleagues that his group wouldn't interfere with their projects, and told them they could still reach out to outside bankers; he just wanted to be part of the process. The ice thawed only after Kravis and Roberts mandated that everyone start using the group extensively.

With the disappearance of major players like Merrill Lynch, Bear Stearns, and Lehman Brothers in 2008, KKR suddenly had an opportunity to pounce. As rivals were wriggling out of loan commitments, "the downturn helped us," says Farr.

STREET CRED ON THE LINE

In November, Farr's team reached a milestone when it served as lead underwriter of an IPO for the first time. The process wasn't as smooth as Farr would have hoped. Back in August, Farr and two members of his 15-person group pitched Dollar General, one of KKR's holdings, to be one of the lead underwriters in its upcoming IPO. Farr promised the white-glove treatment of a boutique firm, and suggested the big banks would view Dollar General as just another transaction. It didn't hurt that KKR owned the company. Dollar General signed on, and Farr's team got to work on the deal. Among other things, Farr's team arranged for Fidelity and Sanford C. Bernstein to distribute the shares to their customers.

But by October the deal was in trouble. The stock market began to slump, and IPOs were performing poorly. KKR insiders feared the Dollar General deal would flop, too. Kravis and Roberts started e-mailing and calling Farr daily to emphasize what he already knew: The offering had to succeed. KKR's Street cred was on the line. "There was a lot of pressure," says Farr.

As the Nov. 12 IPO approached, Farr scrambled. He put two senior members of KKR's deal team on the phone with investors to answer any questions they might have and sussed out which potential investors were likely to hold the stock for a long time and which weren't. The last-minute push worked: General's stock priced within the range KKR had promised and rose 8.2% during its first day in trading. Dollar General raised $716 million. KKR pocketed $10 million as one of three lead underwriters, alongside Goldman and Citigroup.

Farr's team has served KKR's buyout funds in other ways re-

(L TO R) PHOTOGRAPHS BY ADRIAN MOSER/BLOOMBERG NEWS; SANTI BURGOS/BLOOMBERG NEWS



North America and Europe deployed more virtual than physical servers in 2008.
95% of data centers are deploying virtualization
TECHNOLOGY
Gartner VP Neil MacDonald: Virtualization will be the target of new security threats**
88% of North American companies don't have a virtualization security strategy
60% OF PRODUCTION VIRTUAL MACHINES ARE LESS SECURE THAN THEIR PHYSICAL COUNTERPARTS.*
THINK CONVENTIONAL SECURITY CAN PROTECT YOUR VIRTUAL ENVIRONMENT?
THINK AGAIN.
Enterprises around the world are relying on virtualization to increase data center efficiency and, unknowingly, leaving themselves more vulnerable. That's because conventional security isn't able to protect virtual machines or see the traffic between them – leaving data and networks exposed. Which is why, according to Gartner Group, in 2009 sixty percent of virtual machines are less secure than their physical counterparts. But with Trend Micro™ Enterprise Security, powered by the Trend Micro™ Smart Protection Network™ infrastructure, you can mitigate the risk and maximize the benefits of virtualization. It's a different kind of security that protects your physical and virtualized environments and helps set the foundation for your company to move confidently into the cloud.
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© 2009 Trend Micro Inc. All rights reserved. Trend Micro and the t-ball logo are trademarks or registered trademarks of Trend Micro Inc. All other company and/or product names may be trademarks or registered trademarks of their owners. *Per Gartner Group Vice President Neil MacDonald, as quoted in: McLaughlin, Laurianne; "How to Find and Fix 10 Real Security Threats on Your Virtual Servers," CIO Magazine, 14 November 2007, www.cio.com/article/print/154950 **Per Gartner Group Vice President Neil MacDonald, as quoted in: "Gartner: Rush to Virtualization Can Weaken Security," On-Demand Enterprise, 09 April 2007, http://www.on-demandenterprise.com/offthewire/gartner_rush_to_virtualization_can_weaken_security_07-29-2008_08_52_18.html



Roberts and Kravis at the Fairmont Hotel in San Francisco: Their closeness has been key to KKR's success

cently. In July, when outside banks weren't lending, it arranged the loans and debt for KKR to buy the South Korean unit of Anheuscher Busch InBev for $1.8 billion. And it rounded up investors for a significant portion of the debt needed to pull off KKR's Nov. 8 purchase of a Northrop Grumman consulting division for $1.65 billion, with partner General Atlantic. One of the investors was KKR's $13 billion debt fund.

WHAT WILL THE PROS SAY?

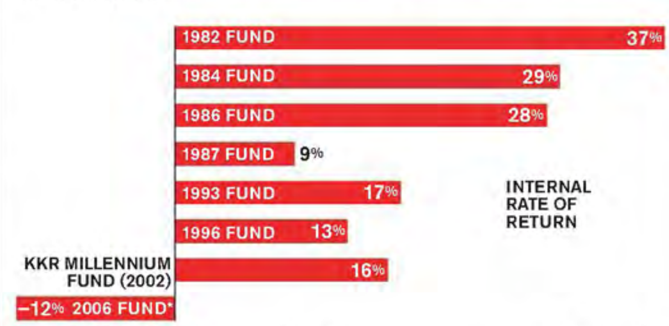
Buffett, who declined to comment for this article, has little affection for private equity. He blasted the industry in his annual shareholders' letter in March, accusing it of piling debt on companies and burdening them with enormous fees. Whereas Berkshire has just $38 billion of debt spread across 76 companies, according to data compiled by Bloomberg, KKR's 51 companies carry at least $170 billion.

One of the reasons Kravis wants to take KKR public is so that he, like Buffett, can use his stock as a tool to buy companies, or slivers of them. Shareholders give Buffett so much lattitude to buy companies in part because he has delivered strong results for them for decades. Kravis wants that kind of freedom, too. "We're not just a private equity firm," says Kravis. "We're an asset management firm. ... If all you're going to do is say you'll buy 100% of companies, you're passing up a lot of opportunities where you can make a lot of money."

Perhaps, but some of the professional investors who put money into KKR funds expecting it to buy and sell companies aren't keen on KKR's taking too many minority investments in public companies, like an ordinary mutual fund. "I'm not opposed" to those deals, says Mario Giannini, CEO of KKR investor Hamilton Lane. "But if there are a lot of them, you have to question if you're paying private equity fees for public eq-

DIMINISHING RETURNS

KKR's recent buyout funds haven't performed nearly as well as older ones



Data: Washington State Investment Board

*Through June

PHOTOGRAPH BY THOMAS BROENING; CHART BY ALBERTO MENA/BW

uity investing." In that sense, Buffett's "perfect private equity model," in Kravis' words, doesn't fully translate to KKR.

One transaction from September illustrates how KKR can play an active role in managing companies even when it doesn't take full control of them. Early in the year two members of KKR's tech group, Herald Y. Chen and Adam H. Clammer, pitched their bosses on an investment in Eastman Kodak. The two had examined taking Kodak private on numerous occasions over the last decade, but for one reason or another it never came to pass. This time both parties were willing to explore all options. Kodak needed cash to expand its ink-jet printer business for retail consumers as well as its commercial printing and scanning businesses. But with the debt markets frozen at the start of 2009, Kodak couldn't raise money cheaply by issuing bonds or taking out loans. It began kicking around the idea of selling a stake instead. For KKR, this presented an opportunity for a new kind of dealmaking: Instead of taking over Kodak outright, it could become a partner.

Chen and Clammer performed due diligence for six months, talking extensively with Farr's capital markets group about how to structure a deal amid such volatile markets. They also reached out to KKR's in-house team of operational executives who parachute into companies to turn them around. And they talked with Fisher, the former Kodak CEO who now works for KKR, about how Kodak's operations could be improved.

As the two sides examined the numbers, Kodak's current CEO, Antonio M. Perez, visited Kravis in New York and Roberts in California. He wanted to know whether they shared his view that Kodak's stock was undervalued and whether they intended to be long-term shareholders. Kravis and Roberts convinced him of both. "That was the key," Perez says. "They believed in the value-creation opportunity we thought we had."

KKR also sold Perez on the potential for Kodak to tap its 51 companies as customers and suppliers. The two sides agreed that KKR would take two seats on Kodak's board and that KKR would deploy its in-house managers to work on new growth opportunities. An hour after the deal closed on Sept. 16, Kodak formed the "K Squared" team, which consists of seven Kodak executives and six KKR operational executives. The group, which meets monthly, aims to find ways Kodak can sell more to KKR's companies, ramp up its sales force, and make acquisitions. Since the deal closed, at least six KKR-owned companies have gotten involved in dialogues with Kodak about how they can work together.

K-Squared hasn't been around long enough to affect Kodak's quarterly profit results. Investors, though, don't seem optimistic. Kodak's long-suffering share price has fallen by 36% since the deal closed. "It's a long-term investment," says Kravis. "We got involved in this because we knew it was a turnaround."

CORE VALUES AND LONGEVITY

For Kravis and Roberts, the biggest challenges in remaking their company may be internal. They'll have to figure out on the fly how to grow quickly without falling prey to Big Company syndrome. With headcount having tripled since 2004, from 204 people to 637, Kravis and Roberts fear KKR could become siloed and bureaucratic. The two now consult regularly with senior adviser Rajat K. Gupta, a former global managing director at McKinsey & Co., for thoughts on the best way to manage the expansion. Gupta saw similar growth at McKinsey: The firm's professional staff grew from 500 to 9,000 during his 35-year tenure there. "The vision," says Gupta, "is to develop a premier global institution for alternative investments."

More than anything, Kravis and Roberts want to create a mature, meritocratic company that will long outlast them. To drive that point home, the two have begun tying part of KKR compensation to how much an executive takes advantage of all the firm's new capabilities.

But Gupta has pressed them to do more, sometimes veering into touchy-feely territory. In May, at Gupta's urging, KKR partners and managing directors from around the world gathered in New York to talk about how they were adhering to the firm's "core values" (integrity, respect, teamwork, excellence, innovation, accountability, fortitude, and sharing). There were no "trust falls" during the four-hour meeting at the New York Sheraton Hotel and Towers, but between bites of deli sandwiches the team discussed how they could improve the way KKR is carrying out its new mission and improve its internal and external communication. Another Gupta idea: As part of the annual 360-degree performance-review process, 12 partners now must conduct in-depth interviews of 72 executives at the firm.

HOW TO PLAY IT 080

These sorts of things don't seem like the province of buyout barons. Then again, what choice do Kravis and Roberts have when the rules of the game have changed? Loading mounds of debt on a company in hopes of selling it later for a big profit is a technique befitting a "cave man," says Kravis. "The days are long gone when you just buy a company and hope that financial engineering will work. Our job today is to create value. Private equity, to me, is acting and thinking like an industrialist." |BW|

–With Jason Kelly and Cristina Alesci

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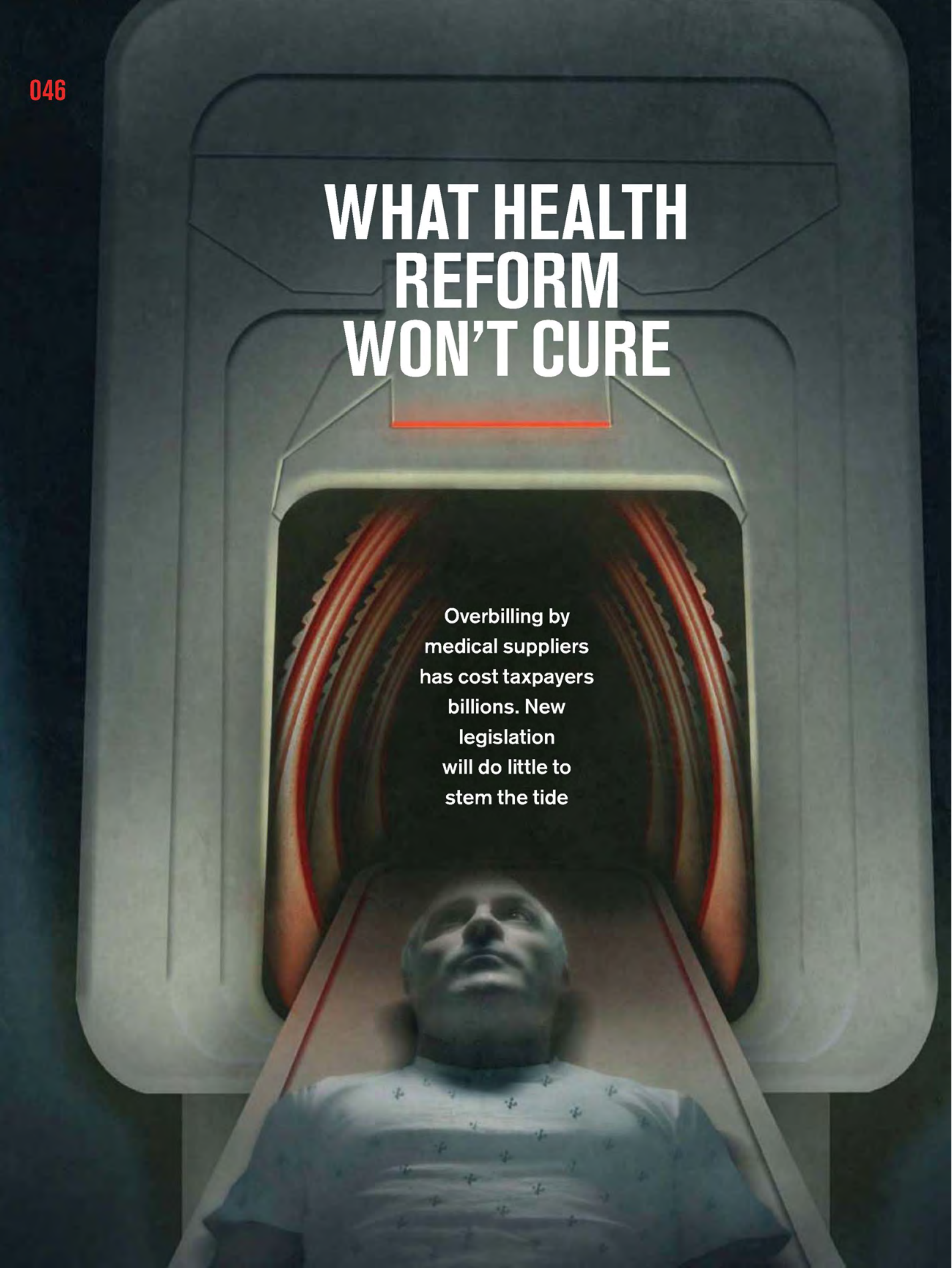
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WHAT HEALTH REFORM WON'T CURE

Overbilling by medical suppliers has cost taxpayers billions. New legislation will do little to stem the tide

President Barack Obama and his Democratic allies on Capitol Hill say that a vast expansion of health coverage can be funded by squeezing out waste and fraud rather than cutting benefits. Whether that turns out to be true may help determine the success of the sweeping reform package being debated by Congress. ¶ Slashing costs is no easy task, and stopping fraud is even tougher. No less than $47 billion in Medicare spending went to dubious claims in the year ended Sept. 30, according to the U.S. Health & Human Services Dept. That's 10.7% of the $440 billion program that subsidizes care for the elderly. Medicaid, the government program for the poor, lets billions trickle away at roughly the same rate. The $10 million annual increase that Congress is allocating to fight fraud may not be enough to do the trick. ¶ One spending sinkhole can be traced to large medical-equipment suppliers, device makers, and pharmaceutical companies, which government auditors and industry veterans describe as a recalcitrant bunch. Medical manufacturers know public agencies generally pay first and ask questions later—if ever. Medicare receives 4.4 million claims daily; fewer than 3% are reviewed before being paid within the legally required 30 days. ¶ One way to get a sense of the scale of the seepage—and the challenge facing the Administration—is to look at whistleblower

By Chad Terhune

Illustration
by Matt Mahurin

lawsuits filed under the federal False Claims Act. That law allows company employees to sue on behalf of the government to recover improperly claimed federal funds.

A suit filed by William A. Thomas, a former senior sales manager at Siemens Medical Solutions USA, one of the nation's largest medical suppliers and a unit of German engineering giant Siemens, offers a case study in the difficulty of containing costs. Thomas, a 15-year Siemens Medical veteran, alleges in federal court in Philadelphia that for years the company overbilled the Veterans Affairs Dept. and other government agencies by hundreds of millions of dollars for MRI and CT scan machines and other expensive equipment. These high-tech systems—used to examine everything from damaged knees to suspected cancers—cost $500,000 to $3 million apiece, sometimes more. Thomas, who retired from Siemens in 2008, claims that with no justification other than larger profits, his former employer charged its government customers far more than private-sector buyers for the same equipment.

"Billions and billions could be saved with the right government regulation and oversight applied to health care," Thomas, 56, says in an interview. "But I think corporations will continue running circles around the federal government."

In court filings, Siemens has denied any wrongdoing and has sought to have the Thomas suit dismissed. A company spokesman, Lance Longwell, declined to elaborate for this article, citing the litigation.

The Thomas suit illustrates some of the vagaries of False Claims Act cases, hundreds of which are filed every year against government contractors in a range of industries. As the plaintiff, Thomas stands to pocket up to 30% of any court recovery, with the rest going to the Treasury. The Justice Dept., which can intervene in such suits to help steer them, announced last year that it will stay out of the case against Siemens for now. Yet Thomas' allegations have helped drive a parallel criminal investigation of Siemens' equipment marketing practices by the Defense Dept. and the U.S. Attorney's Office in Philadelphia.

In April federal investigators searched for records at the headquarters of Siemens Medical in Malvern, Pa., a suburb of Philadelphia. Ed Bradley, special agent-in-charge of the Defense Criminal Investigative Service, confirmed that the investigation is continuing but declined to comment further.

Longwell, the Siemens Medical spokesman, says the company is cooperating with criminal investigators. In March, just weeks before the search of its offices, Siemens won a new $267 million contract to provide radiology equipment to the U.S. military and several federal agencies. Its global health-care division reported a profit of $2.1 billion on revenue of $17.5 billion for fiscal 2009.

POLICING CORPORATIONS

Selected settlements of federal cases involving allegations of health-care industry misconduct

PFIZER
September 2009
$2.3 BILLION
Allegedly promoted unapproved uses for Bextra and other prescription drugs

QUEST DIAGNOSTICS
April 2009
$302 MILLION
Allegedly sold inaccurate and unreliable laboratory test kits

ELI LILLY
January 2009
$1.4 BILLION
Purportedly promoted unapproved uses for antipsychotic drug Zyprexa

*Now owned by Medtronic Data: U.S. Justice Dept.

SCATTERSHOT APPROACH

Whistleblower cases like Thomas' battle with Siemens are an unsystematic way of policing alleged fraud, but one that from time to time can pay off for taxpayers. In September, Pfizer agreed to give the government $2.3 billion to resolve criminal and civil allegations that it illegally promoted the use of several drugs in ways that hadn't been approved by regulators. The settlement—the largest of its kind—was initially triggered by private whistleblower complaints. During the year that ended Sept. 30, the federal government recovered $1.6 billion from health-related suits filed under the False Claims Act.

The case against Siemens turns on federal contracting law that requires vendors to disclose prices and discounts to ensure the government receives the best deals available. Thomas alleges Siemens withheld this kind of information and instructed salespeople to falsify records to avoid detection by government auditors. The former executive alleges the government paid 10% to 44% more than private customers for the same equipment.

A WHISTLEBLOWER SUIT CONTENDS THAT SIEMENS GAVE SOME CLIENTS A 74% DISCOUNT BUT THE GOVERNMENT'S BREAK WAS ONLY 32%

The suit cites a 2005 summary of Siemens equipment discounts, which the company routinely offers to large customers. The average overall discount exceeds the government discount in each of 13 product categories. For instance, the average Siemens discount for ultrasound machines was 58%, while the government discount was 36%. The document lists reductions of up to 74% on CT systems for some clients; the government received a 32% discount.

In court filings, Siemens says it has not misled the government. Some of the disputed pricing information was in fact shared with the government, the company argues, and public agencies continued to purchase the Siemens equipment.

This isn't the first time Siemens has been accused of

wrongdoing in medical contracting. In 2007, Siemens Medical pleaded guilty in federal court in Chicago to obstructing justice by giving false testimony and withholding records involving a $49 million radiology contract for a county hospital. Siemens was ordered to repay Cook County $1.5 million and pay an additional $1 million fine. Prosecutors said Siemens gave a local man $500,000 to pose as a minority business partner to meet the county's affirmative action purchasing rules. Siemens declined to comment on the Illinois case.

Even before passage of any health-reform legislation, the Obama Administration is trying to step up enforcement with help from private informants. "We have such volume [of funding] going through government health programs, it is important to get tips from whistleblowers so we can build cases," says William Corr, Deputy Health & Human Services Secretary. Corr is leading a new antifraud task force formed in May. It has assigned teams of investigators to cities with especially high rates of fraud, such as Miami, Detroit, and Los Angeles. By the end of December, Corr says, the government should have all Medicare claims combined in one database so investigators can detect suspicious patterns faster. Data are now split among several government contractors that audit claims by region.

But some health business veterans doubt that the government can catch up. "I've been in this industry for 30 years, and the federal government hasn't put a dent in fraud and abuse," says Deborah J. Grider, a compliance consultant to medical providers. Without addressing the Siemens case, she adds that for every wrongdoer the government nabs, "there are thousands they don't even know about."

Jeffrey S. Bucholtz, who oversaw False Claims Act enforcement in 2007 and 2008 for the Justice Dept.'s Civil Div., predicts some drugmakers and medical suppliers will resist tougher enforcement. "Companies will increasingly fight back, and the government will have a hard time winning in court," says Bucholtz. He should know: As a partner with the law firm King & Spalding, he now defends the kinds of corporations he used to police. |BW|

BAYER HEALTHCARE

November 2008

$97.5 MILLION

Allegedly paid kickbacks aimed at having patients switched to Bayer products

KYPHON*

May 2008

$75 MILLION

Purportedly persuaded hospitals to overbill for spinal procedures



Thomas claims Siemens told salespeople to falsify records

NANCY NEWBERRY

HEALTH-CARE FRAUD RECOVERIES

Annual amounts obtained by the federal government (in millions):

FISCAL YEAR	MEDICARE RECOVERY	MEDICAID RECOVERY
2008	$1,940	$344
2007	797	266
2006	1,500	177
2005	1,550	64
2004	1,510	99
2003	723	152
2002	1,400	59
2001	1,000	43
2000	577	27

*Medicaid figures exclude state recoveries
Data: U.S. Health & Human Services Dept.

WHY TECH BOWS TO BEST BUY

By Cliff Edwards
Illustration by Thomas Porostocky

As the last major electronics retailer standing, the chain has unparalleled clout. And CEO Brian Dunn means to use it, shaping technologies and helping to develop products.

For the past four years, employees at Best Buy have taken regular tours of what the company called its "retail hospital." A group of about a dozen would don white lab coats, walk a row of real hospital beds, and scan charts describing the maladies afflicting each of the giant retailer's major competitors. But this fall, Best Buy staffers made their last trip to the darkened room on the company's Richfield (Minn.) campus. The retail hospital is closing because all of Best Buy's major rivals have succumbed to terminal illness. "It's kind of like ultimate fighting," says Barry Judge, the company's chief marketing officer. "One retailer goes down, and then who's next?"

At least for now, Best Buy stands as uncontested champ. It's the last major consumer electronics retailer in the country this holiday season, after the liquidation of Circuit City earlier this year. But Brian J. Dunn, who became Best Buy's


BEST
BUY

chief executive officer in June, isn't taking success for granted, especially with rising competition from nontraditional rivals such as Wal-Mart Stores and Amazon.com. So Dunn has ambitious plans to take advantage of Best Buy's newfound clout: He wants to go beyond the typical big-box retailer role of selling commodity products such as televisions and personal computers and become a central player in determining which products come to market and how big-spending customers choose the latest gear.

The plan is already under way. Rather than waiting for electronics makers to ship Best Buy the same products that its rivals get, Dunn's lieutenants are walking factory floors with executives from companies such as Hewlett-Packard and Toshiba, influencing product development and design. The retailer is pushing suppliers to use standardized software and digital services so consumers can listen to music or watch movies on any device. And Best Buy has set up its own venture capital fund to pour millions of dollars into startups from Silicon Valley to Asia. The goal is to shape development of new technologies in promising fields such as green vehicles, digital health, and home monitoring. "We are talking to players deep into engineering the future," says Dunn. "It leads us nicely to a space where we can make a real difference to consumers."



"AVANTE GARDE"

Shoppers wandering Best Buy aisles this holiday season will see the difference. Along with the latest flat-screen TVs, digital camcorders, and computer games, the company's shelves are stocked with exclusive items. Among them: the thinnest laptop on the market, a motorcycle that runs solely on electricity, and a watch-like gadget you attach to your wrist to monitor daily activity and sleep patterns. "We want to become a digital playground where people come in, experience it, try it, and find out how all these things can work together around their life," says Dunn.

The strategy, for all its ambition, could backfire. As Best Buy broadens its focus, it risks clashing with crucial partners. The company is already selling certain products in competition with suppliers, and will likely push other products off store shelves to make room for gear it's developing. Best Buy's new role makes it a kingmaker for companies that play along and a serious threat for those that refuse. "Best Buy is avant-garde in its thinking," says Eugene Fram, a retail expert and professor emeritus at the Rochester Institute of Technology's College of Business. "The big question is whether they can succeed without alienating their partners."

Executives at several major consumer electronics companies worry privately about Best Buy's growing influence. They're concerned that Dunn and his team could block them from getting innovative products in front of customers or favor Best Buy-backed goods over their own. "We used to call them the 800-pound gorilla," says the executive of one company that sells televisions and other products to Best Buy. "Now with a lot of competition gone, they're the 1,000-pound gorilla."

One example of the rising sensitivity is Best Buy's recent move into digital services, including music and movies. The company acquired the online music service Napster a year ago and then took a stake in CinemaNow, Sonic Solution's movie-streaming service, in November. Now the retailer is giving prominent play to Dell computers loaded with Napster, beginning with a free year of the music service, and plans similar promotions with CinemaNow through par-

BEST BUY'S BIG BETS

The last major national consumer-electronics chain is expanding its focus to include all types of connected devices under new CEO Dunn. Here are some key experiments:



ELECTRIC VEHICLES

In May, about two dozen stores in California and Oregon began selling electric vehicles, including bikes, scooters, and gearless motorcycles. The company plans to expand to other states in 2010.



Dunn and his blue crew: "We want to be a digital playground"

be more cooperative than adversarial. "They are so focused on the customer experience, and they give us great insights into how to translate technology for customer needs," he says. "We are both pretty aligned with that."

Dunn is clear about why he's pushing for change. He wants to give Best Buy a strategic edge over other retailers. Slugging it out on price with Wal-Mart, Amazon, and Costco is a brutal business, especially as strapped consumers grow hesitant to buy new televisions and home theater gear. If he can make Best Buy the go-to store to test out the latest gear or get exclusive goodies, he can insulate the company from some of the competition.

SAFE BET

Investors appear optimistic. The company's stock is up more than 80% over the past year, to 44, compared with a 20% increase for the Standard & Poor's 500-stock index. Analysts expect revenues for fiscal year 2010, ending in February, to rise 7.8%, to $48.5 billion, even as profit margins hold steady, according to consensus estimates from Bloomberg. Analyst Thomas Kurey of Gardner Lewis Asset Management, which held about 2 million shares in Best Buy at

ticipating partners. Hardware makers, which usually get paid bounties to load such software on their PCs, may find it tougher to get payments from rival services such as Netflix or Rhapsody if they want a piece of the $300 billion digital services market.

Apple, Sony, and other manufacturers could retaliate if they feel Best Buy is getting too heavy-handed, although they would think long and hard before doing so. They could pull products out of the retailer's stores or forge closer relationships with rivals such as Wal-Mart. Michael Fasulo, Sony Electronics' chief marketing officer, says that so far his company and Best Buy have avoided serious rifts in part because their executives talk every week and the discussions tend to

the end of September, says the company has a very secure position in the tech industry. "The thing about Best Buy is you're not betting on a single technology. Best Buy is going to be there regardless of where technology is," he says. "There's a big swath of customers that are going to want to get a little advice and to touch and feel that new gadget. Best Buy will continue to play an important role in that."

Dunn, now 49, seemed an unlikely future leader when he joined the company in 1985. At 24, he was working off and on and living at home with his mother, Ethel, who prodded him to find a permanent job. She was employed in accounting at Best Buy, which had a dozen stores at the time, and helped him land a position selling VCRs at one Minnesota

MOBILE DEVICES

The retailer has been remodeling stores to emphasize Best Buy Mobile, which sells smartphones, netbooks, and other devices from the four major U.S. wireless carriers. It's also expanding the number of standalone Mobile stores in a bid to capture 15% of U.S. wireless sales by the end of 2010.

ELECTRONIC BOOK READERS

In August the chain began selling two Sony Reader models. In the first quarter, it plans to add devices, such as the IREX digital reader, that wirelessly download books and newspapers.

DIGITAL HEALTH

In November, 40 stores across the U.S. began offering personal health devices such as pedometers, Bluetooth-enabled weight scales, and blood pressure monitors. Best Buy is working closely with Intel and Cisco Systems to develop additional health products.

BEST BUY ON ADVERTISING NETWORK

In early 2010, the chain will begin collecting revenue from companies that want to use its in-store displays of televisions, monitors, and other equipment to advertise movies, music, and products. Procter & Gamble and Samsung have expressed interest.

BRAD TRENT

outlet. The New Jersey native proved a quick study in learning from the best salespeople and managers. He worked his way up and became heir apparent in 2006. Brad Anderson, the previous CEO, says he wanted to stay in the job "until I found a leader who would take the organization farther than I could."

On a recent weekday in New York City, the burly Dunn strolled into a store in Union Square to check out the company's new "discovery zones." In the Best Buy Mobile zone, for instance, dozens of customers were checking out how Motorola's new Droid smartphone stacks up against Apple's iPhone. Although it's too early to tell whether the strategy that lets users try out multiple brands in one place will goose sales and create a more loyal following, Dunn nods approvingly. "What we're able to do is show how all these things can work together," he says. "Convergence is actually here now, and all those roads will lead through the center of our store."

Best Buy isn't the first to try rewriting the rules of tech retailing. Since Apple started opening retail outlets in 2001, the company has turned its sleek stores into magnets for anyone who wants to test-drive an iPod, iPhone, or Mac. Amazon is trying to make up for its lack of physical stores by offering same-day delivery in several big cities.

BEYOND RETAIL

Still, Best Buy's strategic position is unique. It has more than 1,000 stores, compared with Apple's 280, and sells a wide range of competing products, while Steve Jobs' company doesn't. Best Buy has 155,000 people working in its stores, and its 20,000-strong Geek Squad is in the field every day, helping customers set up home electronics or fixing products on the fritz. Through its Reward Zone program, a sort of frequent flier card for shoppers, the retailer has built up a list of more than 2.5 million customers who shell out thousands of dollars every year for the latest tech gear. "Users come into Best Buy for reasonably good answers and solutions to the question of what's the right gadget to buy," says Manish Rathi, co-founder of Retrevo, an online product-tracking and review company. "Wal-Mart can't solve that today. Neither can Amazon."

The job of knowing just how far Best Buy can push before manufacturing partners push back falls in large part to Kal Patel, executive vice-president for emerging business. Former CEO Anderson hired Patel away from the consulting firm Strategos in 2003 to direct the retailer's strategy, and Dunn has given him broad leeway to transform Best Buy into a technology company. Patel suggests, unapologetically, that Best Buy and its partners will have to get used to a new relationship. "If you're in the technology business, we're going to have to learn to deal with constant conflict," he says.

Over the past two years, Patel has virtually lived on planes and in hotel rooms in an attempt to guide the company's technology push by learning from established giants and startups. On a recent trip to California, he huddled with executives at Cisco Systems to discuss partnerships aimed at connecting more consumers to more devices. While prepared for conflict, Patel also found plenty of collaboration.

In late 2007, Craig Bramscher, chief executive of Brammo, started searching for an investor and retail partner for the Enertia powercycle, a full-size motorcycle that drives like an electric scooter, with no clutch, gears, or transmission. He thought Best Buy was a natural fit, since the company already has service bays for car stereo installations. A few months later, while munching on hors d'oeuvres at a dinner party with a longtime friend, he discovered the friend knew Patel, and the two got in touch. "I thought they were the only company innovative enough to take a risk on us," Bramscher says.

Within weeks, 30 Best Buy employees were in Brammo's Ashland, Ore., headquarters to vet the Enertia. The team spent two days in the skunkworks lab, tearing apart the powercycle and grilling Bramscher's team to determine whether it fit into their growth strategy. They ultimately were convinced, and in August 2008, Best Buy invested $10 million in the company. As the retailer began lining up approvals in the test markets of California and Oregon to be licensed as motorcycle dealerships, Dunn sent Bramscher a brief note over Twitter.

BEST BUY'S GROWING INFLUENCE

Its ascent has been slow and steady over the years, but the best days may be yet to come.

	Market share*
1966 **Sound of Music**, the precursor to **Best Buy**, opens its first store in St. Paul, Minn.	0%
1983 The new corporate name **Best Buy** is unveiled, followed by the first superstore, in Burnsville, Minn.	NA
1995 **Best Buy** nearly ties **Circuit City** in consumer electronics market share	8.7%
2002 The retailer acquires technology support company **Geek Squad** for about $3 million.	NA
2004 After expanding into selling music and DVDs, **Best Buy** pushes into Canada and creates the Reward Zone loyalty program.	17%
2005 Rival **CompUSA** shuts down **The Good Guys** chain.	18%
2006 **Best Buy** acquires a majority interest in Chinese retail chain **Jiangsu Five Star Appliance**.	19%
2007 **CompUSA** shutters its 103 stores.	20%
2008 **Sharper Image** closes stores, and regional chain **Tweeter** shuts down. **Best Buy** buys a controlling stake in mobile phone retailer **Carphone Warehouse**.	21%
2009 Longtime rival **Circuit City** liquidates.	22%

*In U.S. consumer electronics
Data: Best Buy

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PC MAKERS, WHO ALREADY MAKE SCANT PROFITS ON SALES, FEAR LOSING THE FEES THEY CHARGED SOFTWARE COMPANIES TO LOAD THEIR PROGRAMS

"We're exercising muscles we didn't know we had," he wrote. Best Buy is now pushing to expand the availability of the Enertia to other states.

Dunn and his team, meanwhile, are working on a variety of similar deals. One key area is health and wellness. Earlier this month, the company launched new fitness zones in 40 stores across the nation that include devices such as a Bluetooth-enabled scale that sends weight information to a computer for charting. Next year the company will introduce a toothbrush that wirelessly reports to a PC the number of brushstrokes that a child uses. "We're scouring the world over, bringing in new talent to help us in a particular space," says Dunn.

The entrepreneurial spirit is filtering down to established businesses. Jason Bonfig, vice-president of the computing division at Best Buy, works closely with Toshiba and other PC makers to create notebooks under the Best Buy-exclusive Blue Label and Next Class brands. Based on customer feedback, the designs include perks such as backlit keyboards, bigger batteries, and custom chassis colors. It used to take weeks for color samples or material choices to make their way from Taiwan to the PC maker, then on to Bonfig in Minnesota. Fed up, Bonfig began joining the manufacturers on trips every six months to set road maps with their subcontractors.

BROADER FOOTPRINT

The cozier relations helped on the eve of the Oct. 22 Windows 7 launch, when HP offered to put together an exclusive bundle for Best Buy that included a desktop PC, monitor, laptop, netbook, and wireless router for $1,199.99. Best Buy also got the exclusive on Dell's sleek new $1,799 Adamo XPS notebook, in part because of its early involvement in the manufacturing process. "When you work closely together, there's more time to innovate elsewhere," Bonfig says.

Conflict still happens. Some top PC makers are upset about Best Buy's recent expansion of a service that lets customers reduce the amount of third-party software installed on new computers. Software companies pay HP, Dell, and others hundreds of millions of dollars a year to install trial versions of their programs for virus protection, photo-editing, and the like on new computers; PC makers get another check if buyers sign up to keep using them. Best Buy lets customers select just one antivirus program, say, and removes alternative products. The retailer's executives say they are simply responding to customer complaints that their new machines are overloaded and sluggish. But PC makers are concerned the retailer is trying to grab more of their scant profit pool.

They may be right. One unusual deal Best Buy has struck is with the antivirus company Kaspersky Lab. The Moscow-based company agreed to let Best Buy manage its software and subscription program in exchange for more prominent placement in stores, says Randy Drawas, Kaspersky's chief marketing officer. "We get a broader footprint within Best Buy and are seen as a premium brand," he says. Best Buy salesmen promote Kaspersky's software, and the retailer gets a slice of the revenues when customers use it. PC makers, though, may lose out on revenues as software from rivals such as McAfee are stripped off machines.

Although it is exerting more influence over the types of software installed on devices, Best Buy says it will continue to sell products from companies that opt out of its programs, such as the one aimed at reducing software clutter. That approach may help Best Buy skirt antitrust issues, even as its share of the U.S. consumer electronics market expands from the current 25%. "I hope we're not seen as picking winners and losers," says Dunn. "What we stand for is choice."

In another move, *Bloomberg BusinessWeek* has learned, Best Buy plans to launch its own advertising business early next year. The company will let movie studios, PC makers, and other companies run trailers, songs, or commercials on the thousands of televisions, PCs, and cell phones within its stores. Sony, Toshiba, and Samsung have already signed on to advertise. Still, the effort could prove controversial since rivals may end up advertising on each other's devices. Dunn won't reveal revenue projections but says the business will "grow into a big piece of what we do."

Dunn clearly relishes this kind of experimentation. As customers drop into stores around the globe this shopping season, they might run into kiosks where they can swap used games or movies, or DJ booths where would-be disc jockeys can pick up digital turntables, headphones, and lighting. Best Buy is testing out different logos and store layouts, even stocking solar panels in a few markets. Many of the tests won't pay off, but Dunn figures the retailer can learn and make adjustments for the future. "The easiest changes are when you are backed up against the corner and it's sort of 'change or perish,'" he says. "Now we're trying to change at a time when we are very, very successful." |BW|

Business Exchange

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Geek Army

Best Buy says that its biggest not-so-secret weapon is the staff of 155,000 employees worldwide who can talk all things electronic. The company's BlueShirts do most of their work in stores. But the retailer is increasingly using social media Web sites such as Twitter and Facebook to bringing young, technologically savvy customers into its stores. More than 2,300 Best Buy staffers now provide customer service through Twitter.

To learn more about the initiative, go to **http://bx.businessweek.com/best-buy/news/reference/**

BRAZIL

Making its mark on the global stage

Part II of a special report on how business-friendly Brazil keeps wowing investors.



Latin America's economic powerhouse, Brazil, is enjoying unprecedented growth and success despite the global financial crisis as political and economic stability generate an attractive and rewarding climate for foreign investors.

Under the leadership of dynamic and charismatic President Luiz Inácio Lula da Silva, Brazil has opened its doors to foreign direct investment (FDI) with both medium- and long-term opportunities in key sectors like health, ICT, retail, energy, and infrastructure.

Large agricultural, mining, manufacturing, and service sectors are also fueling Brazil's economic engine, with this prosperity flowing down through the economy to create a fast-growing middle class with rapidly increasing purchasing power. This robust growth and socioeconomic development are benefiting growing numbers of the nation's 180 million people, with products such as coffee, ethanol, aircraft, automobiles, and textiles bringing in huge export revenues.

Importantly, the flow of goods is not all one way, with investors seeking excellent returns flocking to Brazil to help generate FDI of more than U.S.$200 billion in 2008.

With a deserved reputation as a top tourism destination, thanks to its wonderful climate, beautiful beaches, and magnificent tropical rainforests, Brazil will receive millions of sports fans when it hosts the 2014 soccer World Cup and the 2016 Olympic Games.

The award of hosting rights for the world's two showcase sporting events is further evidence of the excellent and continued progress made by Brazil as it looks to become a major force on the global commercial, industrial, and political scene.

Nowhere is this more apparent than in the country's banking and financial services sector, which is now one of the world's largest and most advanced. A winning combination of solid foundations, strong regulatory frameworks, and an effective Central Bank has enabled Brazil to overcome the global downturn better than most nations. One of the sector's top performers, Bradesco boasts over U.S.$280 billion in total assets and more than 40 million customers across Latin America and beyond. Part of the group's outstanding success is due to the excellent performance of subsidiary Scopus Tecnologia which has revolutionized the group's hi-tech operations.



Marisa's modern and attractive stores offer fashion at affordable prices.

Bradesco was the first bank on the continent to offer Internet banking and its 10.6 million website users now generate up to 4.6 million transactions daily. "We have the most extensive private-sector branch and service networks in Brazil, which enables us to reach a diverse client base," says Candido Leonelli, executive director and managing officer at Bradesco and CEO of Scopus Tecnologia. "Bradesco's success is the result of an efficient combination of talent, systems, and technology. Innovation and a pioneering spirit are key in the consolidation of Bradesco's culture."

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marisa.com.br

Another leading player in the national and international financial services industry, Banco BVA has activities across the board, including commercial and investment banking. The company has maintained a rapid pace of growth despite difficult market conditions and continues to offer investors and customers a wide selection of services. "Our main competitive advantages are our specialization and highly qualified staff," says Banco BVA CEO and director Benedito Ivo Lodo Filho. "The financial sector still has plenty of potential for growth and development."



"SCAC is the leader in cement foundation solutions, thanks to its cutting-edge technology and quality control management."

Angelo Vecchi, President, SCAC

Helping these banking giants succeed in a competitive marketplace is financial sector executive recruitment specialist FESA, which also enjoys a partnership with a leading global search organization. Based in São Paulo and with offices in Rio de Janeiro and Curitiba, FESA provides services to many other industries too, through exclusive recruiting centers and programs. "In the last 14 years we have placed 700 executives in Brazil, a third of which were at CEO level," says Alfredo José Assumpção, FESA CEO and managing partner. "We have grown 1,000% in the past five years and have 85,000 executives on our database."

With a population of nearly 200 million, vast distances between cities, rural areas that produce agricultural products, and an offshore oil and gas sector, Brazil faces a major challenge to construct new infrastructure to underpin economic growth.

Serving various companies in a myriad of sectors, UTC Engenharia is one of Brazil's largest integrated management system providers in the industrial engineering services market. The company has operations in fields such as oil and gas, petrochemicals, energy generation, ironworks, paper and cellulose, metallurgy, construction, and industrial maintenance. "Brazil is a country of opportunities and an excellent place in which to invest," says UTC CEO Ricardo Ribeiro Pessôa. "We have grown significantly since 1998 and are continuing to invest and expand. In the U.S. we are going to work with Petrobras, and in Argentina we are going to work offshore. We are also working in Angola."



Hi-tech companies continue to thrive

With interests and operations in the civil engineering, infrastructure, transportation, ICT, and energy sectors, SCAC delivers a prestigious portfolio of world-class cement foundation solutions for major projects including roads, bridges, and ports. The company offers a range of hi-tech cement solutions to residential and commercial construction projects using its decades of experience operating more than 12,000 foundation sites and supplying a million precast concrete piles. "SCAC has been working in the foundations market for almost 40 years," says president Angelo Vecchi. "We are the leader in our field thanks to our cutting-edge technology and quality control management. Brazil is a huge country. Many production sites are a long way from the coast, and the rail network is very small. A large amount of investment is needed to improve transport infrastructure."

Offering a complete range of services and operations across the Brazilian railway sector, T'Trans has interests in areas such as signaling, control, telecommunications, auxiliary systems, automatic fare-collection, energy, and rolling stock. The firm's expertise and technology provide modern solutions for the refurbishment and production of passenger cars, and it is currently producing 150 rail cars that will run on the São Paulo metro system.

Meanwhile, with a philosophy of entrepreneurial development through solid partnerships, leading foundation and containment group Costa Fortuna has enjoyed solid growth, thanks to its advanced engineering techniques. Specialist engineers and geologists form the bulk of the firm's talented workforce. "We don't just focus on construction works, but also special projects like ports," says director Aldo Corda. The company recently increased its area of operations





by moving into the river and sea works sector as well. It is open to partnering with external players. "We already have partnerships in the U.S., but we are looking for more," director Riccardo Baratta says.

It is not just tangible infrastructure that Brazil is committed to developing, however. The country's ICT sector has mushroomed in recent years as heavy investment in new hardware and software technology revitalizes the industry.

A leading provider of IT services for infrastructure, outsourcing, performance, and management, Cimcorp is one of the largest and most successful IT integrators in Brazil. Founded in 1988, the São Paulo-based company develops various IT projects and solutions for firms in the ICT, finance, government, education, industrial, energy, and oil markets. Cimcorp provides up-to-date monitoring through the use of the latest technology, with its portfolio of clients including major financial institutions and utility companies.

The IT infrastructural giant, which counts half of Brazil's utility companies among its clients, opened a state-of-the-art operations center last year that has strengthened its business model strategy and laid the foundations for future success. "We are having a good year despite the global downturn and are well positioned for future growth," says Cimcorp president, Tadeu Vani Fucci. "In 2007, we grew 70%, in 2008 we grew 20%, and we have strong expectations for 2009. These expectations, and the development of projects for important clients, have fortified our image. We have sent the market a strong message that Cimcorp is an important player—one that is now one of Brazil's top 500 companies."

> "Bradesco's success is the result of an efficient combination of talent, systems, and technology."
>
> **Candido Leonelli, Executive Director, Bradesco and CEO, Scopus**

A key provider of help-desk services to major corporations such as Toyota and Dupont, Asyst Sudamérica has grown 20% year-on-year for the past decade and is confident that this positive trend will continue as Brazil strengthens its presence in global markets.

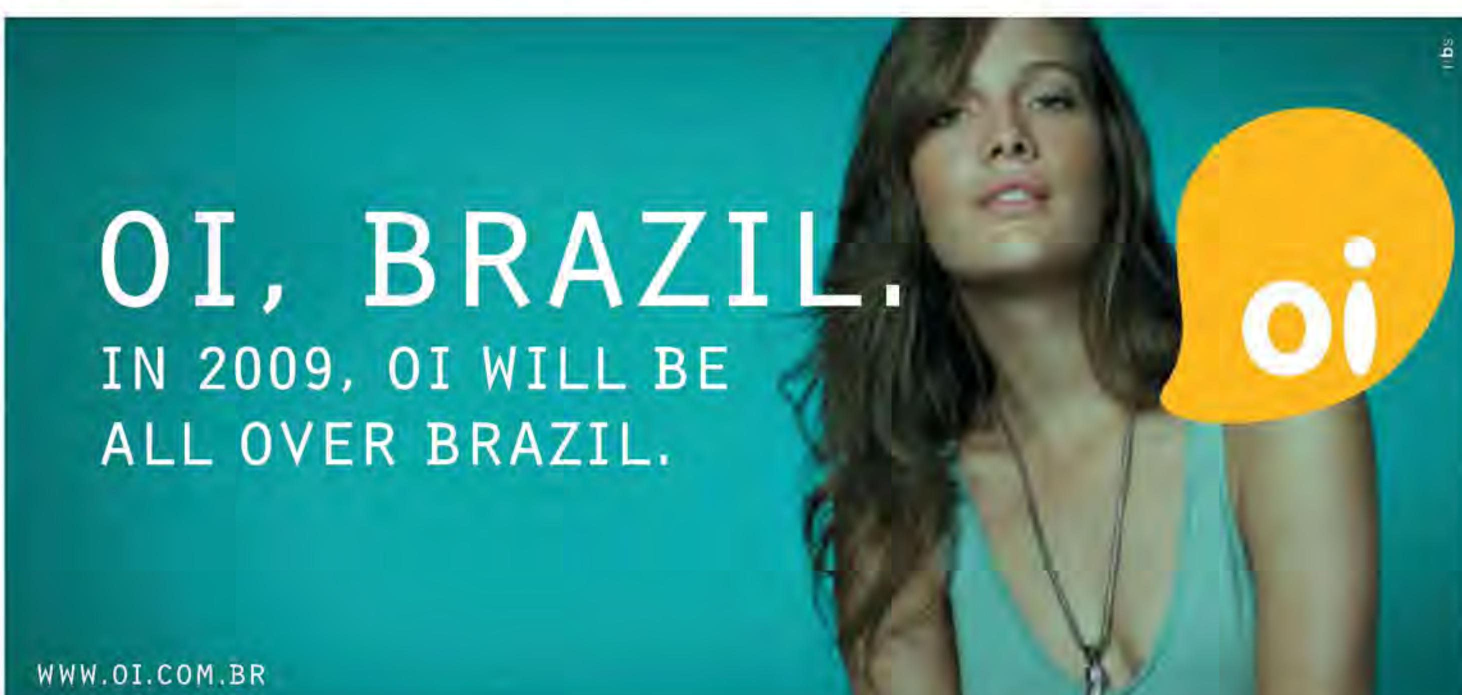
The company has dozens of major clients and delivers IT management solutions to more than 1,000 sites remotely through the use of the latest technologies and systems. "By maintaining longevity with our clients, we guarantee operational excellence and incredible growth," says Francisco Ricardo Blagevitch, new business director and Latin America president. His colleague Oswaldo Brancaglione, processes director and Latin America vice-president, echoes that view, adding: "We offer attractive cost benefits and a guarantee to provide the best quality at the best price. We have six ISO 2000 certificates which illustrate the quality of the first-class services we deliver."

> "Oi is committed to innovation and is very customer-oriented. As Brazil grows, so shall we, by keeping up with the changes in technology."
>
> **Luiz Eduardo Falco, President and CEO, Oi**



Residential customers and government agencies are also benefiting from the wave of developments in the ICT market. Spearheading this innovation drive is telecoms giant Oi—Brazil's largest telecoms operator in terms of revenue. The country's first integrated telecom firm offers an enviable range of cutting-edge ICT products and services, including fixed and mobile phone lines, and fast broadband Internet.

By combining first-class services and streamlined operations, Oi has gained a strong foothold in the lucrative ICT sector and is poised for future growth. "The Brazilian telecoms market has grown considerably since it was privatized a decade ago and has received investments of some U.S.$80 billion," says Oi president and CEO, Luiz Eduardo Falco. "Oi is committed to innovation and is very customer-oriented. As Brazil grows, so shall we, by keeping up with all the changes in technology."



In the meantime, Brazil's retail sector has benefited more than any other from the increased purchasing power of the expanding middle class. In such a cosmopolitan and fashion-conscious nation—São Paulo Fashion Week is now up there with London, Paris, New York, and Milan—the clothing retail segment has undergone massive changes with glittering new malls offering the latest national and international designs that compete with the smaller chains and independent stores.

Homegrown fashion success

One of the country's most successful clothing retailers, and the proud owner of the leading Marisa fashion brand, Lojas Marisa operates more than 200 remodeled stores that sell a wide range of affordable lifestyle apparel, lingerie, and beachwear.

Founded in São Paulo in 1948, the family-run retail giant's core customers are women aged 20-35 in the middle-to-lower income bracket. The best-selling Marisa brand is recognized as young, modern, and sexy, while the firm also sells men's and children's apparel, as well as home textiles. This winning formula of colorful fashion and appealing retail outlets is supported by an attractive website with more than a million registered users. The company's customers also benefit from a range of credit solutions, such as Marisa's own private label credit card, held by more than 12 million shoppers.

With its catchy "Designed by Women for Women" slogan, Marisa has a solid commitment to quality, price, marketing, and customer service, and is perfectly placed to capitalize on the middle class's increased spending strength. "Marisa is the largest seller of intimate fashion in Brazil and has the widest coverage in the segment," says CEO, Marcio Goldfarb. "Marisa is a lively and feminine company that decides what it wants very quickly as illustrated by its decision-making power, which is quick and sharp."



"The trick of the retail segment is to be ahead of your competitors. You need to meet your customers' requirements and be a creator, not a copier."

Marcio Goldfarb, CEO, Lojas Marisa



Marisa exploits visual merchandising techniques to boost sales.

As part of its ambitious expansion drive, the retail giant embarked on a successful high-profile nationwide advertising campaign and through advanced computer software has identified potential sites for 170 new stores. A key competitive advantage is the company's strong network of strategically located distribution centers and a streamlined supply chain. It also boasts a strict quality control system, with many of its suppliers signed up to a program that sees apparel arrive at warehouses already inspected, ironed, and on hangers, with price labels and security devices attached.

One of the key ingredients of Marisa's impressive growth is a substantial investment in visual merchandising that boosts the sale of complementary items, together with well-decorated stores that offer shoppers a pleasant environment. Marisa pioneered the "Freshness Concept" which features the renewal of products on a daily basis.

"Marisa has loyal customers but we must always fight for our brand, nurture it, and grow it," Goldfarb says. "We can't relax by thinking we are the best—we have to respect our competitors and anticipate their moves. Our philosophy is to always look at each store as if it were our only one. The trick of the retail segment is to be ahead of your competitors. You need to meet your customers' requirements and be a creator, not just a copier."

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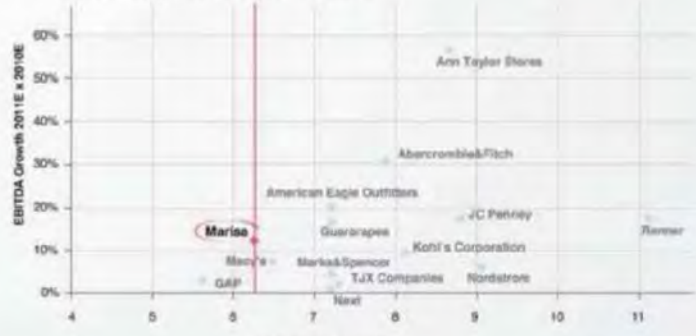








Marisa is the 2nd cheapest company in the Retail Apparent Segment when compared to its global peers



Source: Bloomberg (estimate and stock quotation), Companies (net debt for EV calculation). Date August 13, 2009.

*Note: Marisa's operating and financial information for 2007 and 2008 include all the changes in accounting practices established by Law 11638/07, while the information for 2004, 2005 and 2006 does not include these changes.

Health care gets the private treatment

Medical tourism has a healthy outlook, thanks to innovative private health-care providers.

Brazil's private health sector is developing and expanding at one of the fastest rates in the world, thanks to a growing middle class that prefers to place its medical care in private hands.

And while domestic demand for medical care and services continue to surge, the country is also benefiting from growing numbers of health tourists from the U.S., Canada, Europe, and beyond, who are chasing the best high quality care at reasonable cost.

In addition, with the government particularly keen on promoting investment in science, technology, and research and development, FDI opportunities exist across the entire spectrum of medical services, ranging from hospitals and health clinics, to innovative new drugs and treatments.

Founded in 1992, Grupo Vita specializes in the planning, setting up, and management of medical-hospital units, with the firm's integrated network of hospitals present in cities like Florianópolis, Curitiba, and Volta Redonda. The group has extensive experience and a workforce whose vision and knowledge enables institutions to use the most advanced organizational, administrative, and quality management techniques. "We deliver very high quality services and offer foreign patients the best treatment in the best hospitals at a fraction of the cost they would pay back in their own country," says Grupo Vita president and CEO, Edson Gomes dos Santos.

While São Paulo state is home to Brazil's largest cluster of hospitals and health clinics, the southern state of Porto Alegre is the country's second key center of medical excellence and innovation. One of the region's top providers of medical care, Hospital Moinhos de Vento specializes in oncology, cardiology, neurology, and neurosurgery treatments. A winning combination of high-end technology and first-class patient care has helped the hospital generate annual net revenues of U.S.$102 million. "We are among the best in the world and were the first hospital in this part of Brazil to be certified by the Joint Commission International," says CEO João Polanczyk. "This coveted accreditation acknowledges the quality of the world-class health care we offer, and gives overseas visitors further reassurance as it shows we are internationally recognized for our superb standards and high quality services."

A philanthropic institution and world health center of excellence, Hospital Alemão Oswaldo Cruz was founded 112 years ago and remains one of Brazil's best known providers of outstanding medical care. The hospital, which specializes in oncology and cardiology, assistance to the elderly, and digestive and vascular diseases, is spending



"We showcase our products at industry events around the world and now have representatives in several different countries."

Marlene Schmidt, President, Fanem









around U.S.$58 million on a series of major projects that includes new buildings and equipment. Oswaldo Cruz has enjoyed double-digit revenue growth over the past few years and recently posted annual net revenues of U.S.$115 million.

"We have been chosen as the reference hospital for important personalities during their trips to Brazil," says CEO, José Henrique do Prado Fay. "Our global vision goes beyond the concept of what health tourism is usually based on."

Hospital chairman Karlheinz Pohlmann, adds: "We attend 70,000 patients a year and have partnerships with three German hospitals. We are also starting to work with patients from Chile and Argentina, and have major plans to expand our presence in domestic and international markets."

Serving an aging population

Specializing in making medications for cardiological and rheumatalogical conditions, as well as diabetes and clinical depression, French pharmaceutical company Servier boasts a state-of-the-art U.S.$46 million production plant in Rio de Janeiro.

"The Brazilian population is getting older so there is a greater need for the treatments we specialize in," explains Servier Brazil general director Varso Toppjian. "We sell 14 medicines in Brazil and are aiming to launch an innovative new product every year until 2012. This includes a breakthrough treatment for depression that will change the way the condition is dealt with."

Meanwhile, a pioneer in the design and manufacture of baby-oriented medical equipment since its foundation in 1924, Fanem is a conceptual company whose life-saving products are present in hospitals and clinics across Brazil and 90 countries around the world. As the industry leader, Fanem produces 95% of the country's total incubator and neo-natal sector exports, and has interests in laboratories, diagnostic, and bio-safety sectors.

With its headquarters in São Paulo state and 300 employees, Fanem is also the name behind the best-selling Panda brand of baby products. Of the 450 incubators in the region's top 15 private maternity hospitals and a leading public hospital, some 99% were produced by Fanem.

"We showcase our innovative products at industry events around the world and now have representatives in several countries," says Fanem president, Marlene Schmidt Rodrigues, whose grandfather founded the company in 1924. "I am very happy with our success in overseas markets and delighted to say that our products are being used in the great luxury hospitals of Dubai."

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STRATEGY & COMPETITION

A French Wal-Mart's Global Blitz

Mega-retailer Auchan has a powerful patriarch, a secretive culture, and an insatiable urge to expand

By Carol Matlack

PARIS

Gérard Mulliez is France's Sam Walton: a frugal, plain-talking, small-town entrepreneur who parlayed a single storefront into a sprawling empire. And just as the Wal-Mart Stores founder once did, he's shaking up the world of retailing.

Mulliez is patriarch of a secretive family that controls one of the world's biggest retail operations, with more than 7,000 stores and annual sales of some $95 billion. The family's two-dozen-plus companies include Auchan, a Wal-Mart-like big box; Decathlon, the world's biggest sporting goods retailer; and the European and Latin American operations of Midas muffler. And they're gaining ground against competitors, especially in emerging markets, which hold the key to growth as sales in the U.S. and Western Europe have flattened.

With an estimated $22 billion fortune, the clan is France's wealthiest family. But its leaders go to extremes to avoid publicity. "It's astonishing how little is known about them," says Benoît Boussemart, an economist who published a book on the family last year after Gérard Mulliez ("Mool-YAY") filed an unsuccessful lawsuit to block publication. Mulliez and leaders of the family's major companies either did not respond to or declined *BusinessWeek*'s interview requests.

Even most French people don't realize the extent of the family's holdings. True, $95 billion in sales pales next to Wal-Mart's $405 billion. And it's a good distance behind the $145 billion sales of the global No. 2 retailer, France's Carrefour. But it's neck-and-neck with Britain's Tesco and Germany's Metro, which round out the world's top five retail groups.

In China, Auchan is outperforming rivals by appealing to upwardly mobile shoppers. While Carrefour has designed its stores to mimic raucous street markets, Auchan outlets are more organized. Each of its 145 stores there averages $45 million in annual sales, vs. $26 million for Wal-Mart's mainland outlets, estimates consultancy Planet Retail. Wal-Mart's emphasis on rock-bottom prices "has backfired with Chinese shoppers" who often assume cheaper goods are coun-

A FAMILY AFFAIR

Retailers controlled by the Mulliez clan have annual sales of some $95 billion

BRAND	2008 SALES (billions)	BUSINESS	OUTLETS
Auchan	$58.7	Hypermarkets	1,245 in 13 countries
Leroy Merlin	14.8	Home improvement	452 in 9 countries
Decathlon	7.4	Sporting goods	442 in 14 countries
3 Suisses*	5.5	Catalog/online	Web sites for 24 countries
Midas**	1.9	Auto repairs	1,100 in 11 countries

*44% owned by Mulliez family **Only in Europe and Latin America Data: Company reports, *Bloomberg BusinessWeek*





Auchan thrives in Beijing (left); founder Mulliez (below) retired in 2006, but his extended family controls the empire

terfeit or dangerous, says Shaun Rein, managing director of the China Market Research Group in Shanghai.

Mulliez companies are on a roll in Russia, too. Seven years after opening its first Moscow outlet, Auchan is Russia's top foreign hypermarket operator, with 34 stores and roughly $6 billion in sales this year, Planet Retail says. Wal-Mart and Tesco aren't in Russia, and Carrefour pulled out this fall, only weeks after opening its first two stores there. Now, Decathlon and the family's Leroy Merlin home-improvement chain are piling into Russia. They're getting help from yet another Mulliez business, real estate group Immochan, an Auchan subsidiary that buys property for the family's companies.

NEAR-INVISIBLE NETWORK

Because Auchan is the only Mulliez outfit to publish an annual report, economist Boussemart pored over documents filed with local French authorities. His finding: The empire is remarkably strong. Most of the companies are nearly debt-free. Decathlon, Leroy Merlin, and others have posted double-digit sales and earnings growth for years. Auchan saw sales flatten this year after rising 7.5% in 2008, to $59 billion, but Carrefour and Metro have fared worse.

The network that binds the Mulliez businesses together is strong but nearly invisible. Although legally separate, all are controlled by an extended clan of about 550 people. Now 78, Gérard Mulliez retired from active management in 2006, but his son and various cousins, nephews, and nieces hold top posts in nearly all the businesses. All are privately held, and most are based in the faded industrial region near the French-Belgian border town of Roubaix, where Mulliez opened the first Auchan store in 1961. A family pact lets members trade shares among themselves but bars sales to nonrelatives, so there's no pressure from outsiders seeking quick returns. In some companies, employees are offered shares, but never more than 15% of the total.

The Mulliez family got its start in textiles more than 200 years ago. But by the mid-20th century, that industry was fading, and the younger generation was eager to branch out. Gérard, then 29, set up the first Auchan in an abandoned Roubaix factory after becoming convinced that suburban stores with big parking lots would kill traditional downtown shopping.

The clan is notoriously tightfisted. "You never see them in St. Tropez or buying expensive paintings," says Bertrand Gobin, an author who writes a blog tracking the family. Gobin, who in 2004 was granted a rare interview with Gérard Mulliez, recalls that the patriarch's office was unheated and furnished with a cheap desk, a few chairs, and a table with a sheet thrown over it as a dust cover. The interview lasted five hours, Gobin says, without Mulliez offering so much as a glass of water or even a bathroom break.

For all its retailing prowess, the family has been stymied in the U.S. and Britain. Auchan and Decathlon each opened a handful of U.S. stores in the 1980s and '90s but later pulled out. Rug retailer Tapis Saint Maclou won a bidding war for Britain's Allied Carpets in 1999 but resold the business this year after sales slumped.

That hasn't dulled the family's appetite for global expansion. Auchan is now opening its first stores in Ukraine while pushing into the Persian Gulf. It plans to raise money for China with a stock listing for a retail joint venture with Taiwan's Ruentex Investment Group. And Decathlon, after years of lackluster performance in Britain, hopes to capitalize on the 2012 London Olympics by opening at least five new British outlets before the Games. "We've had a few years now to adapt our business model," says Stéphan Veyret, Decathlon's British property director. "We think we've found the right recipe." |BW|

(TOP TO BOTTOM) PHOTOGRAPHS BY RAPHAËL FOURNIER/SIPA PRESS; PASCAL SITTLER/REA/REDUX



Lady Gaga: Viewers tend to watch music videos over and over

STRATEGY & COMPETITION

I Want My... Vevo?

The famously fractured music industry bands together to launch an ad-driven music video Web site

By Tom Lowry

On Dec. 8 the music industry threw a star-studded bash in Manhattan to celebrate the launch of its long-awaited music site, Vevo. Its main backers—Universal Music, Sony Music Entertainment, and EMI Group—hope Vevo will help turn around the sagging recording industry. Rihanna, 50 Cent, Bono, Mary J. Blige, and other stars mingled at a SoHo event space and sipped wine.

The artists weren't exactly brimming with enthusiasm, though. "Nothing will 'save' the music business," Sheryl Crow told reporters. "But every little thing helps." Mariah Carey quipped: "Isn't it great we can come together and salvage something that used to be special?" It's also telling that Warner Music Group is so far sitting out the Vevo experiment.

For years record labels saw music videos as just another tool to sell CDs. Now, with album sales down more than 52% since their peak in 2000, the industry sees videos as a potential advertising gold mine—or at least a silver mine. Since music videos account for much of YouTube's traffic, the recording companies figured: Why not build our own service and sell ads on it? "This isn't enough to compensate the industry for the billions they've lost as the CD became irrelevant," says Forrester Research analyst James McQuivey. "But it's a piece of the revenue puzzle."

LIKE HULU, BUT DIFFERENT

Vevo's goal, says CEO Rio Caraeff, is to "enhance" music fans' experience by providing a central location for premium quality videos as well as bonus materials about the artists and their songs. Vevo, which has its own YouTube channel, is the music industry's version of Hulu, the TV and movie site operated by NBC, Fox, and ABC.

Of course, Hulu isn't making money, though there are differences between the models. While people tend to watch a TV episode once or twice, they devour music videos over and over. Lady Gaga's *Bad Romance* video has been watched 35 million times on YouTube, says McQuivey, yet a TV show on Hulu is lucky to get 3 million views. Vevo's audience could be much larger than Hulu's. A Vevo insider says 1 billion Sony and Universal video views on YouTube each month will be transferred to Vevo—and that doesn't count videos from EMI and the indie labels.

Some 20 advertisers signed on for Vevo's launch, including AT&T, McDonald's, MasterCard, and Elizabeth Arden. Vevo will let companies create interactive features with fans—branded playlists, for instance—and sponsor original programming, such as behind-the-scenes concert tour series. The risk is that Vevo clutters its site with too many ads: spots before the videos, display ads around them, and ads that overlay the videos themselves. That could turn off fans used to a less intrusive experience.

Warner has a different approach. It believes Vevo's portal-like service diminishes the only brands that matter in music: the artists. The company makes sure any video it puts online drives fans to artists' own sites. It's easy to see why. Warner has signed half of its 1,000 or so artists to so-called 360 deals, where the company gets a cut of ticket and merchandise sales, even fan club dues. What's more, when Warner syndicates its videos to, say, AOL Music, it continues to control the advertising. "Experience demonstrates that everyone—artists, fans, labels, advertisers—benefits most when consumers are connected directly with artists," says Michael Nash, a Warner executive.

It's a win-win for Warner Music CEO Edgar Bronfman Jr. If Vevo fails, he looks prescient. If it succeeds, he can always join the party. |BW|



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Companies Jump Into The Financing Gap

As banks pull back, more corporations are extending credit to their customers

By David Henry

Companies are turning out to be the unsung heroes of the credit crunch. So-called trade credit, essentially company-to-company IOUs for goods and services, has held steady at $2.15 trillion this year. By comparison, bank lending to businesses declined 6.7%, to $1.5 trillion. "You have to sell a product," says William S. Veatch, an attorney at Morrison & Foerster. "If you can do that by extending credit, it's a smart business move."

The strategy isn't new. Many large industrial players such as Paccar and Caterpillar established financing arms years ago to make loans to customers. The units apply strict standards and operate like a traditional lender. Amid the recession, other types of companies have begun offering flexible financing options, generally on a case-by-case basis through their sales teams.

The strategy—whether formal or informal—is controversial. By making loans or pushing off payments, a company reduces its cash flow and increases its accounts receivable, the money owed by customers. The fear among some investors, especially in the current environment, is that troubled customers will never pay those bills. And if the buyers go belly-up, the company gets stuck with the losses. More than 11% of high-yield corporate borrowers defaulted in the past 12 months, according to Standard & Poor's.

Such risks prompted Caterpillar to take a hard look at its 25-year-old financing group earlier this year. After a three-month study by Goldman Sachs, Lazard, and JPMorgan Chase, Caterpillar concluded that, with banks retreating, customer credit was critical. The bankers also said the financing group would be an important part of expanding the business, particularly in developing markets.

Dolan Media started tweaking its financing terms to expand its business. The Minneapolis publisher of trade journals has been trying to beef up a unit that processes mortgage default paperwork for law firms. To attract clients, Dolan offers them up to 45 days to pay, levying a higher fee for customers that decide up front to put off the bill. "We are continuing to try to gain share in doing these types of services," says Vicki Duncomb, Dolan's chief financial officer.

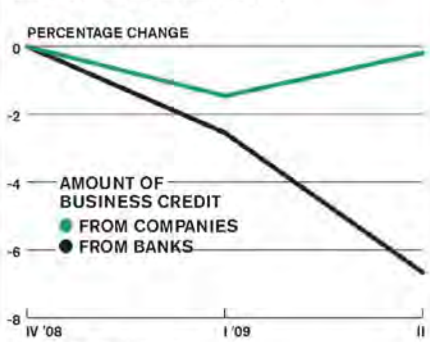


Other companies are filling the lending void to protect their business. Compellent Technologies, a fast-growing data storage company, has allowed select customers ensnared by the credit contraction to defer payments. Companies such as Compellent aren't advertising their efforts. The worry: If other clients learn of the favorable deals, they'll want the same. "We occasionally use the strength of our balance sheet to bring in some customers we wouldn't have otherwise," says CFO Jack Judd. Revenues at the company surged 31% in the third quarter from the previous year.

Tight lending standards are critical. Paccar, the maker of Kenworth and Peterbilt trucks, regularly plays the role of creditor. In trucking, banks pull back about every six to seven years when the industry goes into a cyclical slump. As that happens, Paccar increases its financing from 25% to 30% of the total sales. Paccar digs into its customers' financials. That's kept bad loans under control: Accounts past due peaked at 4.9% this year, a lower level than the two previous recessions. "[Paccar] is not the lender of last resort," says Robin Easton, the company's treasurer. "Every deal we do needs to stand on its own two feet." |BW|

STEADY LENDING

Companies continue to dole out credit while banks retreat



Data: Federal Reserve

DOUGLAS B. JONES; CHART BY DAVID FOSTER



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Major Surgery At Sanofi

CEO Chris Viehbacher's new ideas and charm offensive are reversing the drugmaker's losing streak

By Trista Kelley and Albertina Torsoli

PARIS

The mood was grim at sanofi-aventis when Chris Viehbacher became CEO a year ago. U.S. regulators had rejected the French drugmaker's heralded obesity pill, Acomplia. Sanofi had failed in its legal bid to block generic copies of Plavix, a blood thinner with annual sales of nearly $4 billion. It faced patent expirations on some of its other best-selling drugs, and its labs weren't creating products fast enough to make up for revenues that would be lost to generics.

A year later, some of those challenges still loom—not least the need to create more blockbusters. But much of the gloom has lifted, and many credit the energetic 49-year-old CEO. Recognizing that creating medicines from scratch is a long process rife with uncertainty, Viehbacher eliminated several internal research projects, announced plans to shut or sell 8 of sanofi's 27 production plants, and went on a $9 billion shopping spree, acquiring small, up-and-coming drugmakers in California, Mexico, and Brazil. He has also courted investors and the media more aggressively than his predecessors.

Viehbacher's acquisition binge and charm offensive have worked, at least for some investors. Since a low in March, sanofi stock has jumped 33%. Its shares have returned 22% this year including dividends—the best performance among the world's top 10 drugmakers. Analyst Mark Clark of Deutsche Bank says the stock, still among the cheapest in the industry, could gain 12% in the next year as more investors buy into Viehbacher's strategy. "We see him as a guy with a story to tell, whose stock is undervalued," says Gregg Tenser, a managing director at NWQ Investment Management of Los Angeles.

U.S. biotech executives and members of the media got a taste of Viehbacher the extrovert when he hosted a seven-hour scientific conference outside Boston in November, then led reporters on a tour of the company's flu vaccine plant in Swiftwater, Pa. Under his predecessor, Gérard Le Fur, sanofi used to hold earnings calls at the usual time in Paris, meaning 2 a.m. New York time. That's over. On Oct. 30, Viehbacher was in the U.S. for the company's third-quarter earnings announcement, doing live television interviews from the floor of the New York Stock Exchange.

PATENT PROTECTION

A native of Kitchener, Ont., Viehbacher has Canadian and German citizenship and is fluent in French, German, and English. He joined sanofi from GlaxoSmithKline, where he worked 20 years, rising to head of the North American pharmaceutical unit. He left London-based Glaxo after losing the top job to Andrew Witty. Soon after taking over at sanofi, he began contemplating acquisitions to fill the drug pipeline and speed expansion in emerging markets. Within months he was signing deals in vaccines and animal health—two areas relatively unaffected by patent expirations.

The new CEO

Viehbacher has plans "to fundamentally restructure the sales profile"





GETTING IT RIGHT

Since last year, sanofi-aventis has outperformed its European peers



Data: Bloomberg

quickly replaced the top finance chief and created an executive slot to oversee acquisitions and strategy. "He has a sense of the deal," says Laurence Debroux, sanofi's chief strategic officer—the position Viehbacher created.

"CREATIVE DEALS"

Some of the most striking changes have been in biotech. But sanofi wasn't "known in the industry for doing creative deals," says Hoyoung Huh, CEO of BiPar Sciences, which sanofi acquired in April in a deal that may be worth as much as $500 million. That changed when Viehbacher, who collects wine from Bordeaux, persuaded Huh to visit Paris. " 'Just stop in, even if it's just for lunch. We promise at least to give you good French wine,' " Huh recalls Viehbacher saying. "I went in, I sat down. He said, 'Look, this isn't only good French wine, we're trying to transform the company. On top of that we'd like to potentially have BiPar as a West Coast center of innovation.' "

With BiPar, sanofi gained the experimental cancer drug BSI-201, giving it a new foothold in oncology, a high-growth area. Viehbacher next bought the rights to another cancer drug being tested by veteran California biotech Exelixis. "I want to fundamentally restructure the sales profile of the company so that we can achieve more sustainable growth," he said in a phone interview.

Viehbacher still needs to make his transformation pay off. Products that account for 20% of annual revenue will lose patent protection by 2013. And sanofi shares still sell for just 8.2 times next year's forecast earnings, the third-lowest in the Bloomberg Europe Pharmaceutical Index. Viehbacher has told analysts he will trim nearly $3 billion in costs and keep 2013 earnings and sales at least at 2008 levels, but "he still has a lot of investors to convince," says Eric Bleines, a money manager at CCR Actions in Paris, which holds about $30 million of sanofi shares.

On top of that, workers aren't fond of Viehbacher's strategy. He intends to cut 1,300 research jobs in France next year, out of a total of about 6,400 such posts in the country, according to Thierry Bodin, a labor union representative at the drugmaker. The CEO is more concerned about rewarding investors than developing the company's research programs, says Bodin, adding: "Mr. Viehbacher is Mr. Restructuring." Jean-Marc Podvin, a spokesman for sanofi in Paris, says about 1,100 research employees in France are eligible for voluntary departures.

Viehbacher contends his 12 months in office have made a difference. "A year ago this was a company facing a major patent cliff, not enough new products, a lot of doubt about research and development capability," he says. Tenser of NWQ Investment backs him up. "His no-nonsense approach really made us sit up and take notice," Tenser says. "That in and of itself might not make the stock price go up, but it is a significant step in the right direction." |BW|

Business Exchange

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Drugs for Emerging Markets
Viehbacher is expanding the company's footprint around the globe. But can sanofi earn profits in the Third World? Viehbacher explains how it's possible in a Nov. 23 Q&A with *The Financial Times.*

To read this interview and related stories, go to **http://bx.businessweek.com/pharmaceuticals-companies/reference/**

VINCENT LIGNIER/CORBIS OUTLINE

My Drug's Better Than Your Drug

Pharmaceutical makers, once wary of head-to-head trials, now embrace them as marketing tools

By Arlene Weintraub and Pat Wechsler

Roche announced on Dec. 2 that its experimental diabetes drug performed better in a trial than Merck's $2 billion-a-year blockbuster Januvia. This gave the Swiss giant potent bragging rights—and it was part of a pattern. Six weeks earlier, Roche trumpeted data showing its treatment was superior to a diabetes drug from Eli Lilly. Next year it will wrap up two more trials, pitting its drug against diabetes products from sanofi-aventis and Japan's Takeda.

Drug companies have always been ambivalent about this kind of head-to-head trial. Executives fear they'll spend millions on such tests only to find their drugs don't stack up against the competition. But the health-care reform debate is forcing them to face a new reality: Washington wants proof that expensive therapies are as good as or better than cheaper alternatives. A bill being debated in the U.S. Senate proposes setting up a nonprofit institute to perform "comparative effectiveness" research, which would pit therapies against each other in controlled trials.



GLUEKIT

EASY TO SPIN

So drugmakers are learning to live with comparative trials—and are even flaunting the results. They're weaving the information into marketing messages, much to the chagrin of longtime industry critics. Spinning data is relatively easy because companies are not always required to publicize trials that don't go their way. And if the results are mixed, drugmakers can tweak the message to accentuate the positive. Who should sort all this out? "There have to be rules of evidence in a neutral forum that can be trusted," says Sean Tunis, founder of the Center for Medical Technology & Policy in Baltimore.

Buried in Roche's diabetes trial announcement is the information that patients taking its drug sometimes reported nausea and vomiting. But no details are provided about how the drug compared with Merck's Januvia on side effects. That makes Barclays Capital drug industry analyst Tony Butler suspicious. "I think it will bear out that Roche's side effects are high," he says. Roche won't reveal further details until the trial is accepted for presentation at a medical meeting. In a written statement, Merck says: "We look forward to reviewing the complete results."

The drug industry has long been under pressure to prove its new treatments are worth the expense to patients and payers. Some overseas regulatory agencies won't approve drugs without head-to-head tests. And health insurers around the world yearn to compare popular treatments in crowded categories such as diabetes and cardiovascular disease.

In the U.S., insurers are designing their own head-to-head trials, in part to eliminate drugmaker bias in the comparisons. Pharmacy benefits manager Medco recently started a three-year trial comparing Plavix, a blood thinner sold in the U.S. by Bristol-Myers Squibb, with a newer rival, Eli Lilly's Effient. The Medco study will be completed in 2012, right about the time Plavix loses its patent protection and becomes an inexpensive generic option.

Felix W. Frueh, a Medco vice-president, says that the Effient vs. Plavix study will examine how genetic variations affect patient response to the drugs. He says identifying the people likely to benefit from one drug over the other will be a plus for everyone. Medco has slotted 10 such trials in 2010 alone to analyze the effectiveness of various treatments at the behest of insurance company clients. But some critics worry such trials could become a tool to deny coverage on drugs that only help small slices of the population.

Health-care reformers largely support comparative effectiveness but say it delivers on its promise only when all the data is transparent. That may be difficult in a world where drugmakers control the information, says Dr. Jerome P. Kassirer, a professor at Tufts University School of Medicine. "It's naive to think companies are doing anything but marketing," he says. |BW|



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In Michigan, an Answer To the Jobs Crisis



ROY RITCHIE/WONDERFUL MACHINE

By backing loans to small manufacturers, the state is helping companies diversify—if they add workers

By John Tozzi

SMALL BIZ

Wolverine Metal Stamping in St. Joseph, Mich., has long been trying to diversify beyond automotive clients. To do so, Wolverine needs capital. That's been increasingly hard for small manufacturers to come by as their assets, used as collateral for bank loans, have depreciated during the recession and, in many cases, the auto industry's collapse. Now, a fund sponsored by the Michigan Economic Development Corp. (MEDC) is providing collateral so companies can get loans to shift away from autos. "Existing programs try to help the health of the lender," says Ned Staebler, vice-president for capital access at MEDC, citing the bank bailouts. "The commercial businesses need to be healthier too."

The depreciation of collateral has been severe. A company that had collateral valued at $6 million three years ago could now see those same assets appraised for $2 million, says Ed Mounce, commercial services manager at OMNI Community Credit Union in Battle Creek, Mich., because of the glut of real estate and equipment.

To buy the robots, steel, and presses it needs to diversify, Wolverine had lined up a $2.5 million loan from GE Capital as of September 2008. While a spokesperson says GE doesn't com-

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Kestler's company was starting to diversify when it hit funding snags

ment on individual credit decisions, Wolverine's chief financial officer, Bruce Weber, says GE backed out the day after Lehman Brothers collapsed. For over a year, he says, "we've been trying to get the exact same financing done"—but during that time Wolverine's machinery had depreciated by 20%. Meanwhile, the company booked $10 million in new business with such appliance makers as Whirlpool.

With help from the MEDC-sponsored Michigan Supplier Diversification Fund, the 65-person, $15 million Wolverine is finally getting its loan. OMNI is lending $2.5 million, while getting $1 million in so-called collateral support from the fund. To provide this backing, the fund makes deposits to lending institutions of up to 50% of a loan's value, to a maximum of $2.4 million. That money acts as cash collateral for the business, bolstering the bank's balance sheet and decreasing as the loan is paid down. In return, businesses pledge to create jobs. Weber says Wolverine has brought back almost half the 30 workers laid off this year and plans to rehire the rest by summer. MEDC's Staebler estimates that every $5,000 spent by the fund creates or saves a job. The fund expects a 5% to 6% default rate.

MEDC ran through its $13.2 million fund by making nine loans in four months. About 700 to 1,000 of the state's small manufacturers need funds to diversify. Trade organizations say Michigan companies could use $1 billion in such support, and Staebler says a $10 billion national program could save or create up to 2 million jobs.

Mark One was starting to diversify when it hit funding snags. The Gaylord (Mich.) company, with $10 million in sales, makes machinery used to clean and prep metal surfaces. In 2006, Mark One began developing a more efficient, chemical-free process, drawing interest from a large industrial packager that makes steel drums. Carmakers made up all of Mark One's sales four years ago, but contributed just 10% this year, leaving CEO Frank Kestler to rely on packagers and metal processors. "The banks were retreating from Michigan ... because of the decline in the automotive industry," Kestler says. With a $3 million loan from Huntington National Bank, backed by $1.2 million in collateral support, Mark One plans to double its staff of 50 in three years. That may do little to dent Michigan's 15.1% jobless rate, but it's a start. |BW|



Still Wanted: Foreign Talent—and Visas

With the U.S. jobless rate at 10%, continued hiring of workers from abroad may stoke controversy

By Moira Herbst

Even as job losses in the U.S. mount, employers have stepped up the hiring of skilled workers from abroad, according to data from the U.S. Citizenship & Immigration Services. The acceleration in recent weeks has put companies close to exhausting the 65,000 visas allotted each year for foreign hires under what's known as the H-1B program. Some 61,500 visas had been used as of Dec. 8, and the last visas are likely to be claimed within weeks. Once that happens, companies won't be able to use the program to bring in additional workers until October, the start of the government's fiscal year.

Top Visa Users

Companies that in fiscal 2009 brought the most foreign workers into the U.S. on H-1B visas

Wipro	1,964
Microsoft	1,318
Intel	723
IBM India	695
Patni Americas	609
Larsen & Toubro Infotech	602
Ernst & Young	481
Infosys Technologies	440
UST Global	344
Deloitte Consulting	328

Data: U.S. Citizenship & Immigration Services



"The numbers are surprising, considering the state of the economy," says Ron Hira, associate professor of public policy at Rochester Institute of Technology. "With 15.4 million people unemployed in the U.S., employers should be able to find qualified workers here." The H-1B program allows employers to sponsor skilled workers from overseas for up to three years, with the possibility of extending for additional years.

DECLINING NUMBERS

The mix of companies receiving work visas is changing in ways that could dull at least some criticism of the program. In past years outsourcing companies, including many based in India, have received a substantial chunk of the visas. That's led opponents to charge that the program was being used to send American jobs abroad, since many H-1B employees train at client sites in the U.S. and then rotate back to their home countries to handle similar tasks. But the number of visas received by many non-U.S. outsourcers is declining. Of the top 200 recipients of H-1B visas in fiscal 2009, ended in September, offshore outsourcers got about 22%, or 5,663, down from 38% in fiscal 2008.

Non-U.S. outsourcers still claimed 6 of the top 10 places in fiscal 2009, although the numbers were off for the largest operators. India's Infosys Technologies topped the list in fiscal 2008, with 4,559 visas, but last year got only 440. Wipro was the largest visa recipient in 2009, with 1,964, down from 2,678 in 2008. Sridhar Ramasubbu, Wipro's chief financial officer for international operations, says the drop is the result of lower demand caused by the recession and changes in the company's workforce. "We're now operating in 58 countries," he says.

U.S. companies have become more active in the program. Of the top 200 recipients in 2009, American businesses accounted for 49% of the visas, up from 43% in 2008. Microsoft was No. 2 on the list with 1,318 approvals, while Intel ranked No. 3 with 723. The chip giant says it's using the visas to recruit for high-skill posts in software and component design. "We only use visas for job categories with a [domestic] skills shortage," says spokeswoman Lisa Malloy.

With the Obama Administration struggling to create jobs, politicians are debating whether the visa program needs fundamental change. On Nov. 19, Senators Bernie Sanders (I-Vt.) and Charles Grassley (R-Iowa) introduced a bill to bar major companies that lay off U.S. workers from hiring foreign labor through H-1B and other programs. The legislation, which faces significant hurdles, would apply to companies that have cut 50 or more employees within the past year. "We have a responsibility to ensure that companies do not use the temporary guest-worker program to replace American workers with cheaper labor from overseas," says Sanders. |BW|

RICHARD MIA

Face-Lift for the One-Armed Bandit

The gambling industry hopes to lure a younger crowd with video-game-inspired slot machines

By Christopher Palmeri

In the new The Lord of the Rings game from WMS Industries, players follow a map through Middle-Earth scoring points and bonus rounds. Lightning bolts flash and strike the earth on screen while speakers under the seat produce a thunderous rumble. Typing in a user name and password, players can store their scores. There's one difference from an arcade game, though: This machine can pay out tens of thousands of dollars to casino patrons.

The traditional one-armed bandit is being replaced these days with more sophisticated slot machines that incorporate 70-inch video monitors, 3D graphics, and group competition—all borrowed from the video-game and movie businesses. While the payouts are still based on chance, your game skills help you move to new levels. It's a textbook example of a mature industry making a gutsy bid to reach beyond its core customer—women 55 years old and up—to a younger demographic. By awarding fictional medals and incorporating video and sound effects, slot makers hope to bring more gamblers back to the casinos, which have seen a 6% decline in revenue this year.

Waukegan (Ill.)-based WMS, a former pinball machine maker, is one of the pioneers. In 2000, Chairman Brian R. Gamache began hiring video-game industry veterans—including Larry J. Pacey, a former Sega executive WMS named chief innovation officer—to pump fresh energy into the business. WMS reorganized its game designers into 10 studios, each with a separate studio head, a stable of mathematicians, and some graphic artists, and started searching for smart gimmicks from outside the gambling industry. "We asked ourselves, what would a casino look like if it adopted the technology everyone else had: interactivity, networked devices, IMAX-like screens, digital sound?" Pacey recalls.



This new slot machine will lead players through Middle-Earth as lightning flashes

NETWORKED MACHINES

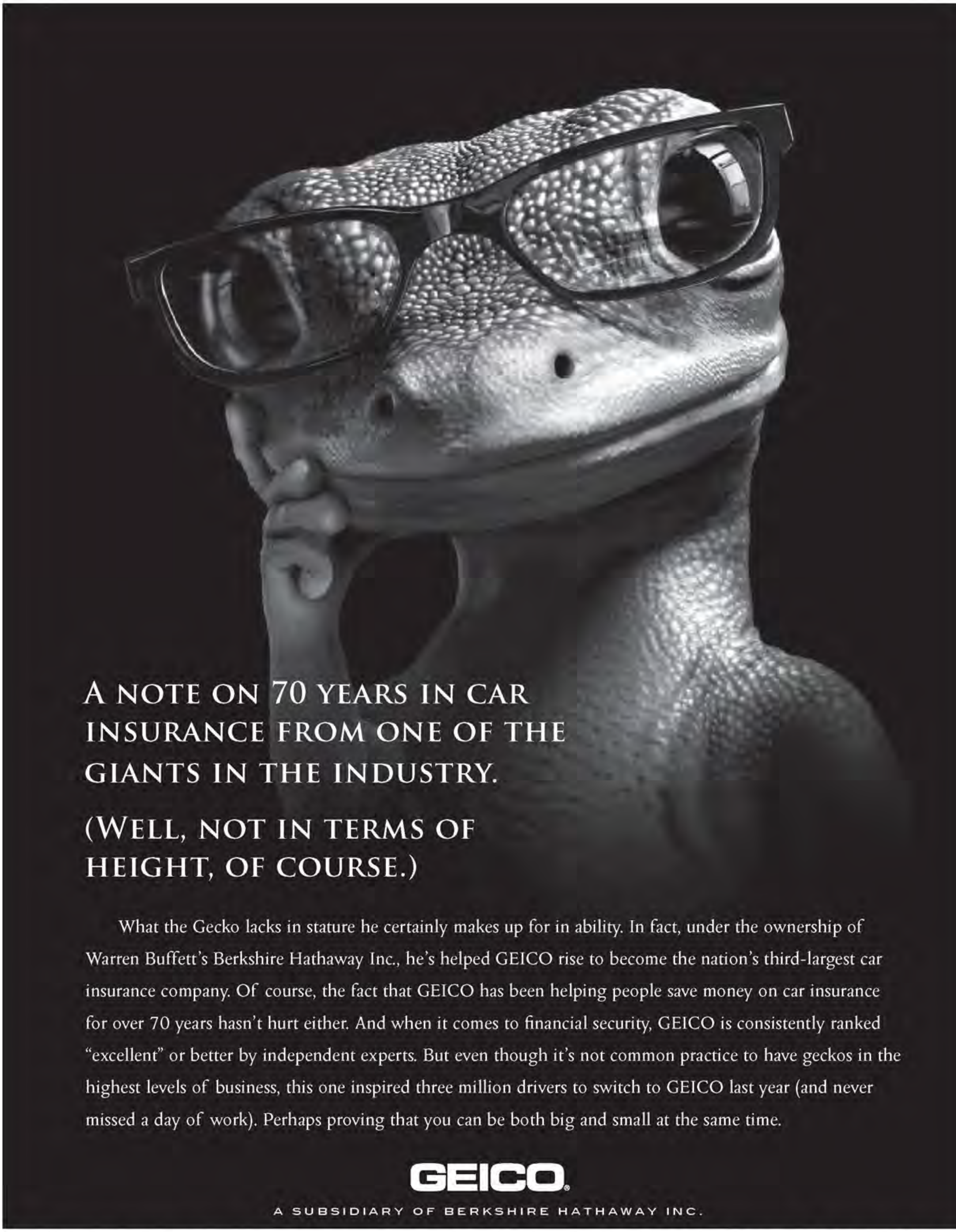
Video-game glitz was in the spotlight at the Global Gaming Expo, the slot machine trade show held in Las Vegas in late November. At the large, elevated booth of industry leader International Game Technology, visitors inspected a game based on the *Sex and the City* TV show. Players spin a video version of a roulette wheel, egged on by the voice of star Chris "Mr. Big" Noth. Rival Bally Technologies unveiled its new DualVision games for couples, who sit on a love seat and share the same pool of funds but are able to play their own games on separate screens.

> **A bet that slot players will enjoy being egged on by *Sex and the City*'s Mr. Big as they spin a video roulette wheel**

Next up is a long-anticipated transition to server-based slots. On Dec. 16, MGM Mirage will unveil the first fully networked slot machine floor at its new Aria Resort & Casino in Las Vegas. The idea is that casino floor managers can adjust the minimum bets, percentages paid out to players, and even the game on the machine, remotely. Previously this was done by technicians with screwdrivers, or through expensive upgrades to the machine.

With this technology, casino managers can hike minimum bets on busy nights, much as they do for table games such as blackjack today, to increase revenues. "It's a classic technology evolution that brings more efficiency," says Eric P. Tom, IGT's executive vice-president of sales and marketing.

Such advances always bring risks. Servers are hackable, for one. And casinos will have to assure customers they aren't using the technology to rig the bets. The Nevada State Gaming Control Board says there are "security requirements at every level" and monitoring of all game-altering transactions. But consultant Harvey Perkins with Spectrum Gaming Group says "customers look for excuses to explain why they lost. This may give them another: The casino changed the game." |BW|



GEICO is the third-largest private passenger auto insurer in the United States based on 2008 market share data as reported by the National Association of Insurance Commissioners, March 2009. At December 31, 2008 Government Employees Insurance Company had admitted assets of $12.5 billion, and policyholder surplus of $4.1 billion (including $33.4 million in paid up capital stock). Total liabilities were $8.4 billion, including $7.7 billion in reserves. Additional information is available at: http://www.geico.com/about/corporate/financial-information. Government Employees Insurance Co. • GEICO General Insurance Co. • GEICO Indemnity Co. • GEICO Casualty Co. These companies are subsidiaries of Berkshire Hathaway Inc. GEICO: Washington, D.C. 20076. GEICO Gecko image © 1999 – 2009. © 2009 GEICO

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PERSONAL BUSINESS

VALUE PLAYS

PRICE IS RIGHT?

After shunning large lending companies, billionaire value investor Michael Price bought shares of Bank of America in its $19.3 billion equity sale on Dec. 3, and says he plans to buy more. The company, whose stock fell 66% in 2008, plans to repay $45 billion in Troubled Asset Relief Program (TARP) funds.

Price says Charlotte (N.C.)-based BofA is the only large U.S. bank that he owns. Its price could rise above $20 if profit reaches $2 a share, he says. The average per-share profit estimate of analysts surveyed by Bloomberg is 96¢ for 2010 and $2.10 for 2011. BofA's stock is up about 10% this year. –*Lynn Thomasson and Deirdre Bolton*

MONEY REPORT

OPEN FRONTIERS

Stocks in emerging Europe, the Middle East, and Africa will rise 31% by the end of 2010 as cheap valuations, fast profit growth, and higher oil prices draw investors, according to a Dec. 3 Morgan Stanley report. Michael Wang, the company's London-based emerging-markets strategist, wrote that the gain he expects from the MSCI EM EMEA (Emerging Markets Europe, Middle East, and Africa) Index would exceed the 20% estimated gain for global emerging markets. EMEA stocks trade at a 30% discount to global peers in the MSCI Emerging Markets Index on a price-to-earnings basis, Wang writes, and profits in the regions are expected to grow 46% in 2010. Energy and raw materials companies make up 40% of the index. For a broad play, Fidelity's Emerging Europe, Middle East, & Africa EMEA Fund buys stocks in all three regions. A number of exchange-traded funds, including Claymore/BNY Mellon Frontier Markets ETF and PowerShares MENA Frontier Countries Portfolio, also invest in frontier nations in these areas. –*Michael Patterson, with Tara Kalwarski*



Data: Bloomberg



MUTUAL FUNDS

A BOND STAR IS BOOTED

Is the high number of recent departures from TCW a sign that it's time for investors to bail out of its bond funds? Following the Los Angeles-based asset manager's Dec. 4 announcement that Chief Investment Officer Jeffrey Gundlach had been "relieved of his duties," the remaining members of his team have resigned, according to Bloomberg. Since his ouster—said to be due to internal power struggles—Gundlach has said he's considering starting his own firm, a prospect likely to intrigue investors: Over the past 10 years that Gundlach has managed the TCW Total Return Bond Fund, he's bested Bill Gross's Pimco Total Return Fund by almost 4 percentage points. The TCW fund's assets have swelled to nearly $12 billion, thanks to Gundlach's navigation of the mortgage securities market at the height of the credit crisis. Eric Jacobson, Morningstar's head of fixed income research, says "there's no immediate need to go anywhere." TCW, he notes, has brought in a group of managers from Metropolitan West Asset Management who can, for now, "credibly and ably manage the money." –*T.K.*

OMAHA ON THE HUDSON

(FROM PAGE 038)

By Jason Kelly and Cristina Alesci

Kohlberg Kravis & Roberts' long-awaited debut as a publicly traded firm is reviving the debate over whether private equity can please two masters. ¶ Pension funds, endowments, and wealthy families made KKR's founders and their buyout brethren billionaires by pouring $1.2 trillion into ever-larger funds that the private equity managers used to buy companies. The funds returned rich profits to those so-called limited partners.

Now, KKR, like larger rivals Blackstone Group and buyout/hedge fund manager Fortress Investment Group, is also beholden to public stockholders. They own a stake in the firm through the 30% of KKR the firm listed in Amsterdam this summer. KKR is expected to shift its listing from Amsterdam's exchange to the New York Stock Exchange in early 2010.

Here's the rub: Strapped limited partners, stung by losses in private equity, hedge funds, and publicly traded stocks and bonds, are pressing managers to reduce the fees funds earn from managing money. They worry that KKR's incentive to create outsize returns by turning around companies has been reduced by the stream of fees that have swelled along with the company's assets. There is also pressure on the profits firms take from successful investments.

Those same fees are the main source of revenues public investors are counting on for earnings growth and dividends. "The firms' private investors may grumble because it changes the basic economic incentives and structure that made private equity attractive in the first place," says David Watson, a partner and chairman of the private investment funds practice at law firm Goodwin Procter.

KKR founders Henry Kravis and George Roberts say the interests of their private and public investors are aligned more than ever. KKR shares with private fund investors about 80% of the fees it collects for services such as monitoring companies. More important, KKR and Blackstone are diversifying. KKR's expansion of businesses such as its capital markets arm—the firm earns fees from underwriting stock and debt offerings of companies it owns—helps smooth the fee stream. That makes earnings more predictable, and attractive to investors.

The potential to generate fee income from assets under management is what Credit Suisse analyst Howard Chen urges his clients to focus on when evaluating Blackstone. Such fees, he says, would make the swings in its private equity portfolio values less troublesome. In a note he sent to clients on Dec. 2, he argued that shareholders may have an advantage over private fund investors, since they can benefit from all of Blackstone's lines of business, not just individual funds.

PRIVATE EQUITY PLAYS

STOCK/TICKER	PRICE	COMMENT
Blackstone Group/BX	13.65	Blackstone went public at the end of the LBO boom; the stock has doubled this year yet still trades at half its IPO price
Fortress Investment Group/FIG	4.04	Bankruptcies in Fortress' buyout portfolio and hedge fund woes have hurt its share price
AP Alternative Assets/AAA*	6.76	Apollo Global Management, parent of this European publicly traded fund, has filed for a listing in the U.S. on the NYSE
3i Group/III**	277.5	Europe's biggest publicly traded private equity firm has sold assets and shut divisions to cut debt

Data: Bloomberg; prices as of Dec. 7 *Listed on Amsterdam Stock Exchange **Listed in London; price in pence

The market reacted coolly to shares of Blackstone and Fortress. The stocks are down 57% and 79%, respectively, since they went public in 2007. By comparison, the Bloomberg World Diversified Financial Services Index is down 42% since the start of 2007. Even so, other buyout firms may follow KKR's lead and go public. Apollo Global Management, which trades shares on a private Goldman Sachs exchange, has filed to list on the NYSE. Carlyle Group has said it has weighed its own IPO. It may be that Blackstone's travails pave a smoother road for the next wave of IPOs, as investors warm to the concept of public private equity. |BW|

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STOCKS VS. BONDS

TAX-SMART, STATE BY STATE

By Lewis Braham

It's a given for many academics and investors that over the long run stocks outperform bonds. But those in the top tax bracket may want to rethink that axiom, especially if they live in states with high income tax rates. That's because for tax purposes, most states generally don't treat stock gains or dividends any differently than ordinary income.

For example, in such states as California and New Jersey, taxable investors face not only the 15% federal tax on long-term capital gains but an additional 10% in state income tax on those gains. So you can see how the equation might begin to change when comparing stocks with tax-free municipal bonds.

Private wealth manager Niall Gannon of the Gannon Group in St. Louis spends much of his time trying to maximize his clients' aftertax returns. According to research he conducted for an upcoming book, *Investing Strategies for the High Net-Worth Investor,* factoring in just federal taxes (not state taxes) for wealthy investors reduces the 9.15% annualized return of the Standard & Poor's 500-stock index from 1957 through 2008 to 6.62%. Deducting California's 10% income tax reduces the return further, to 5.95%. Worse still, an actively managed mutual fund that frequently trades stocks would produce more short-term capital gains taxed at higher rates. Running the same pretax numbers for a fund with a 100% turnover ratio—an indication that every position in the fund is sold within a year—the after-tax return dropped to 4.59% in California. By contrast, tax-free muni bonds produced an average 5.45% annualized return during the same period with minimal downside risk.

YIELD PREMIUMS

Gannon has a healthy slug of munis in his clients' portfolios, but that doesn't mean he always favors them over stocks. He has developed what he calls an aftertax calculator that computes an expected aftertax return for each asset class. Currently, because average long-term muni bond yields, at 4.2%, are lower than they often have been in the past, he sees some extra return—what he calls "a risk premium"—to be gained by owning stocks even in high-tax states. "In a state like Oregon, which has an 11% income tax rate, you get a risk premium in stocks of 1.69 percentage points over munis," Gannon says. "In a no-tax state such as Nevada, the risk premium is 2.72 points."

To calculate the premium, he compares the average muni yield with the average stock's earnings yield, which is the inverse of its price-earning ratio. He then subtracts taxes. If the aftertax yield on a stock is higher than the yield on munis, the stock's yield offers the necessary risk premium.

Because of the higher premium in Nevada and other no-tax states such as Florida,

NICK LOWNES



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Wyoming, and Texas, Gannon thinks it might be worth increasing allocations somewhat to stocks in such states. "I think 10% more in stocks in Nevada wouldn't be unreasonable," he says. (That's 10% on top of whatever an investor's existing allocation is in stocks.) Gannon wouldn't go overboard: The fixed income side of a portfolio, he notes, is meant to keep a portfolio stable and provide steady income.

In an example of how people can draw different conclusions from the same data, Curt Fintel, chief investment strategist at Portland (Ore.) wealth manager CTC Consulting, would recommend the opposite of what Gannon says, given a similar high-tax vs. no-tax scenario. He'd allocate more to stocks in the high-tax state and less in the no-tax one. "If you have a target growth rate in your portfolio, you may need to be more aggressive with stocks to meet your goals in the high-tax state since your aftertax return is less," he says. In one analysis Fintel ran, in order to generate the same aftertax return of 6.75%, his calculations called for an increase in stock exposure from 31% to 48% in the high (10%) income tax state, while the muni allocation fell from 50% to 44%. Meanwhile, because of the additional stock exposure, the volatility of the high-tax portfolio went up—a trade-off to achieve a higher return.

Since wealthy investors' portfolios can be complex, customization is needed to get the allocations right. And because of the intricacies of tax codes, exceptions exist to every rule. Jeffrey Horvitz has written extensively on tax-efficient investing and manages the assets of a single wealthy family—his own—as principal of Moreland Management in Beverly, Mass. Horvitz has concluded that munis serve no purpose in his case. "If you have no or minimal tax deductions relative to your income, munis make a lot of sense," he says. "But most high net worth people have a lot of deductions they use to reduce ordinary income. Real estate taxes, investment and trust fees, and state income taxes are deductible against ordinary income for federal tax filings. If you invest in municipal bonds, you may lose those deductions—and actually have lower aftertax returns."

Gannon says in his clients' cases the benefits of owning muni bonds outweigh the loss of the deductions: "Even if you factor in deductions," he says, "there is still usually a big spread in aftertax returns between municipal bonds and, say, Treasury bonds."

"Even if you factor in deductions, there is still usually a big spread in aftertax returns between [munis] and, say, Treasury bonds"

MAJOR EVENTS

Wealthy investors' state of residence can affect their tax bills in myriad other ways. Two of the most significant have to do with large taxable events such as the sale of a business or retirement. States treat capital gains on the sale of a business as ordinary income. People who sell "a business in Oregon for a gain of $10 million will pay $1 million dollars more in taxes than if they went across the border to sell in Washington, which has no income tax," says Gannon. Meanwhile, 19 states have their own unique estate taxes.

Some investors try to relocate to a zero-tax state to avoid a big tax hit. In fact, many retirees move to states such as Florida prior to withdrawing money from their 401(k)s and being taxed at New York or California rates. But "if you move out of a high-tax state, sometimes the tax laws of the state follow you, and you could wind up in court if you try to avoid paying the tax," warns Thomas Muldowney, managing director of Savant Capital Management, a wealth management company in Rockford, Ill. "Laws vary by state, but typically you have to maintain your new state of residence for three to five years for your previous state's tax laws not to have any impact."

Muldowney is quick to point out that income

STATE TAX BURDENS

Even if your state has no income tax, you could still take a hit. The right-hand column below shows overall taxes in a state as a percentage of per capita income.

STATE	TOP INCOME TAX RATE*	TAX BURDEN**
Alaska	0.00%	6.40%
California	10.55	10.50
Florida	0.00	7.40
Hawaii	11.00	10.60
Iowa	8.98	9.30
Nevada	0.00	6.60
New Jersey	10.75	11.80
New York	8.97	11.70
Oregon	11.00	9.40
South Dakota	0.00	7.90
Texas	0.00	8.40
Vermont	9.40	10.30
Washington	0.00	8.90
Wyoming	0.00	7.00

Data: Tax Foundation *Top income tax rates as of July 1, 2009
**Fiscal year 2008 calculation as of August 2008 of total taxes collected in the state, divided by total state income



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taxes are only part of the state tax equation. There are also property taxes, sales taxes, estate, business, and corporate taxes. One survey of state tax rates by the Tax Foundation, a Washington think tank, ranks states by their total overall taxes as a percentage of per capita income. In the latest ranking, New Jersey was the highest tax state, collecting 11.8% of its citizens' per capita income in taxes while the average state collected 9.7%. For investors in the top bracket, the numbers would be higher. "If all you wanted was the lowest tax drag, you'd probably move to Alaska, which has an average tax burden of 6.4%," says Muldowney. While his is not a view universally held, he cites "one drawback" to that plan: "It's Alaska." |BW|

A COMEBACK FOR MUNIS

It's budget deficits be damned as tax-sensitive investors pile in

The Great Recession may be winding down, but state and local government finances continue to deteriorate. California, the eighth-largest economy in the world, keeps treading on the edge of fiscal disaster. Nine other states aren't in much better shape, according to a recent study by the Pew Center on the States. Even after taking into account aid from Washington, state governments face a combined projected budget deficit of $350 billion over fiscal years 2010 and 2011, according to the Center on Budget & Policy Priorities.

Investors are reacting by snapping up tax-exempt bonds. No, they haven't taken leave of their senses. The average long-term return for tax-exempt bonds is 4% to 5%. But last year was miserable, with high-quality munis falling by 5% and more risky munis by 20%. This year the market has rebounded sharply. Long-term muni bond funds are up 17% as of Dec. 3, according to Morningstar. Intermediate muni funds have risen by almost 12% over the same period and short-term munis by nearly 6%. "In the future, returns should be more in line with historic norms," says Hugh McGuirk, who heads T. Rowe Price's muni team.

This nervous normalcy in the muni market is largely the reflection of a new balance between forces of supply and demand. The popularity with state and local governments of Build America Bonds—taxable securities with interest payments subsidized by the federal government—is slashing issuance of long-term tax-exempt securities. The demand for tax-exempts is up, too. The new money flowing into tax-exempt mutual funds this year is on track to reach some $70 billion, well above the previous yearly record of $38 billion in 1993.

DOWNGRADE THREAT

One reason for the embrace of munis is an expectation that taxes will go up. Also, yields are attractive relative to comparable Treasuries, especially for those in top tax brackets. For instance, the dividend yield on the Vanguard Long-Term Tax Exempt fund is 4.43%. The yield on the Vanguard Long-Term U.S. Treasury fund is 4.0%. Yet an investor in the 35% tax bracket would need the taxable-equivalent yield of 6.82% to best the tax-exempt fund. For a resident of California, with its 9.3% upper-income tax bracket, the taxable-equivalent yield on Vanguard's California fund, the Vanguard CA Long-Term Tax-Exempt, is 7.43%.

Still, what about those yawning budget deficits? State government defaults are rare (Arkansas was the only state to go into default during the Great Depression). A number of states could have their debt downgraded this year, though—Illinois, in fact, was downgraded from A1 to A2 on Dec. 7.

The muni bond has fundamentally changed, too. In 2007 half the market was backed by specialized insurance companies. But muni bond insurance has almost disappeared, a casualty of the credit crunch. "We now look a lot like the corporate bond market," says John Cummings, head of the muni bond desk at Pimco. "We are a credit market. People now have to know that not all AA-rated and A-rated bonds are the same."

Investors are sensibly seeking a measure of safety by sticking with high-quality general obligation bonds, which are backed by the taxing power of the issuer. When buying revenue bonds, which are supported by fees, investors are seeking out bonds backed by revenues from so-called essential services, with the classic examples being water and sewer bonds. Leslie Beck, a certified financial planner with her eponymous firm in Palo Alto, also considers revenue bonds issued by the Los Angeles and San Francisco airports as being backed by an essential service, but would steer clear of secondary airports such as nearby Reid-Hillview Airport of Santa Clara County.

Munis won't be boring for awhile. But after the turmoil of the past few years, a nervous normalcy sounds pretty good.

–By Christopher Farrell

090 Books: Mauboussin's *Think Twice*
092 Outside Shot: How happiness happens

TECH & YOU | RICH JAROSLOVSKY



Double Vision

Barnes & Noble's Nook does most things the Amazon's Kindle does—only more slowly



The Nook and the Kindle: Their $259 price includes use of AT&T's 3G network

The Nook is finally here. It turns out to be much less Kindle-killer than Kindle-clone, and a slow one at that. ¶ Barnes & Noble's new electronic book reader, which just went on sale, bears a striking resemblance to the Amazon.com device that ignited the e-reader market. It adds some useful features the Kindle doesn't have, and many of those it lacks won't be missed. But the Nook falls short in one critical area: speed. In just about every important function—opening a book, turning pages, and especially starting up—it lags behind its competitor.

How slow is it on start-up? Achingly slow. Might-as-well-go-pour-yourself-a-cup-of-coffee slow. Amazon's current model, Kindle 2, takes about three seconds from the moment you release the power button until you can start reading. On the Nook, it takes a minute and 50 seconds.

Luckily, most users let an e-reader go to sleep rather than power it down, making the Nook's pokiness less evident. Still, speed is a glaring issue—one that Barnes & Noble says it's aware of and promises to address in a software update early next year.

Once it's up and running, the Nook looks and acts like the Kindle. The key component—a 6-inch black-and-white display—is the same on both

KINDLE VS. NOOK

They're roughly the same size, shape, and price. They use the same technology for displaying text. But there are some important differences:

	THE GOOD	THE BAD
Nook	Includes an additional color screen, permits friends to borrow downloaded books from one another, and allows free browsing of entire books when the user is in a Barnes & Noble store.	Slow to boot up, format text, and display it on the screen. Color screen and Wi-Fi connection drain battery life.
Kindle	Lighter and faster than the Nook, it boasts longer battery life, and each of its features has been thoroughly tested in the market.	The physical keyboard seems clunky and unnecessary. And it lacks some clever features, such as lending rights.

units. And for each, the $259 price includes use of AT&T's 3G wireless network for browsing and downloading books, newspapers, and magazines.

The Nook, which adds a Wi-Fi connection, is a bit shorter, narrower, and thicker than the Kindle, and about 1 ounce heavier. You turn pages by pressing arrows alongside the display; there are two pairs, so left-handers and right-handers are treated equally.

The most noticeable physical difference comes below the book display. In place of the Kindle's rows of tiny keys and joystick, the Nook substitutes a color touchscreen that's used for navigating the contents of your library and the online Barnes & Noble bookstore, and for adjusting the device's settings.

I shed no tears at the lack of a keyboard; I've always found the Kindle's of limited use and prefer the Nook's virtual one for making a note or searching the online store. Also unmourned are a rudimentary Web browser and a text-to-speech feature. The Kindle has both —and the latter set off alarms among publishers as a potential threat to their audiobook revenue.

The Nook's touchscreen provides a little eye candy, particularly in the mode—similar to Apple's Cover Flow interface—that lets you flip through the contents of your library or the online store. That's offset, though, by the adverse impact on battery life. Barnes & Noble says the Nook can go 10 days between charges with wireless off, compared with 14 days for the Kindle. I haven't had the Nook long enough to test its claim, but with the Wi-Fi on and using the Nook often but not continuously, the battery indicator dropped from 100% to 40% in less than 36 hours.

Given that books bought over the 3G network usually arrive in less than five minutes, you may want to turn Wi-Fi off unless you're in one of Barnes & Noble's brick-and-mortar stores. There, the Nook will recognize its mother ship and use the Wi-Fi link to pop up welcoming messages and in-store offers. And you can access the full contents of any e-book in the store, just as if you'd pulled a book off the shelf.

Another potentially nifty feature is the ability to lend digital books to a friend who's using a Nook or an iPhone or a computer running Barnes & Noble's e-reader software. If your offer to lend is accepted, the book appears on the borrower's device for 14 days, while it's locked on yours for the same period. The two-week loan can't be extended, nor can the book be lent a second time. While that's a bit of a drag, at least you're guaranteed to get your book back. Not all publishers will let their books be lent, but Barnes & Noble says more than half of the commercial e-books in its million-title store will be available.

The Nook may also benefit from being a more open platform than the Kindle. Unlike Amazon, which uses a proprietary book format, the Nook supports the ePub standard, which may allow it to access books from a wider variety of sources, including Google's book project. The Nook also uses Google's Android mobile operating system, which means someday it could run additional applications.

That's important if, like me, you're skeptical of the long-range prospects for dedicated e-readers. I believe there's a good chance smartphones or tablets of the sort Apple is rumored to be developing will be the preferred means for accessing print content.

Before Barnes & Noble spends much time on the Nook's future, though, it needs to deal with the present. Early adopters can only hope the company moves more quickly than the Nook currently does. |BW|

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The Limits of Going With Your Gut

How do we make such bad decisions? By knowing too little and moving too fast, for starters

Among the most galling aspects of the financial crisis is that intelligent people made so many decisions that later seemed obviously, pathetically wrong. Greed, and even a certain mean-spiritedness, were evident in the choices bankers, mortgage brokers, appraisers, and many others made. But maybe the most important failure was cognitive: People thought about risks and consequences (if they did at all) the wrong way. That's what Michael J. Mauboussin argues in *Think Twice: Harnessing the Power of Counterintuition*. As he writes: "To make good decisions, you frequently must think twice—and that's something our minds would rather not do." Reality is complex; our repertoire limited.

Explaining how our brains work is a topic of enduring interest, and in recent years it has become a preoccupation among economists and investors. Mauboussin, the chief investment strategist at Legg Mason Capital Management, has written a book for the rest of us, one that has a light touch but is still substantial.

So what causes us to make such dumb, hugely consequential mistakes? We're born that way, says Mauboussin. Drawing on research from psychologists, political scientists, and economists, he details eight of the most common mistakes we make. One is the tendency to misjudge behavior, especially our own; another is the confounding of cause and effect. My favorite describes the dangers of looking for answers in all the wrong places. These categories are less distinct than one might wish, but each chapter contains useful lessons and advice about how we can outsmart ourselves.

We can train our intuition to be more reliable, says Mauboussin. But smarter decisions simply tend to take more effort

The title, Think Twice, surely was intended to play off Malcolm Gladwell's best-selling *Blink*, about rapid cognition, or decisions made in the blink of an eye. Yet Mauboussin doesn't make too much of this. A section called "Trust Your Blink Only If You Practice Blinking" offers the gentlest of rebukes, followed by some sharp analysis. In one recent study, Mauboussin notes, half of 1,000 top executives surveyed said they rely on intuition to make decisions. But intuition only works well in "stable environments, where conditions remain largely unchanged, where feedback is clear, and where cause-and-effect relationships are linear," Mauboussin contends. To clarify, he introduces the ideas of psychologist and Nobel Prize winner Daniel Kahneman, who described two systems of decision-making. The first is experiential: It's fast, automatic, and difficult to control. The second is analytical: It's slower, serial, and takes effort. Mauboussin says we can try to train our gut to produce more reliable responses. But it's better, he suggests, simply to recognize the limits of intuition.

Further along, the author brings a different perspective to the complexities that underlie our choices. Most of us have a deep desire to understand cause and effect—leading us to draw conclusions that only appear logical. We think we can make sense of an ant colony by watching what one ant does. Mauboussin cites a study by Harvard Business School that monitored the performance of 1,000 acclaimed equity analysts over a decade as they were lured to other firms. Guess what? They didn't do nearly as well in their new jobs. Mauboussin points out that while these stars had considerable skill, some of their success hinged on the workplace itself. The resources and reputation of a company, the relationships within, the flow of information—all of these affect how even the most talented among us perform.

The challenge is to resist our inclination to draw simple and lasting conclusions from dynamic situations. Mauboussin calls this the halo effect, or "the human proclivity to make specific inferences based on general impressions." Consider the many management consultants—O.K., and a lot of journalists, too—who mistake circumstance, fortunate or not, for talent or the lack thereof. "We tend to observe financially successful companies and attach attributes (for example, great leadership, visionary strategy, tight financial controls) to that success, and recommend that others embrace the attributes to achieve their own success." We're just deluding ourselves, he says. Success comes about by some mysterious commingling of skill and luck. If you don't believe that, think again. |BW|



Think Twice: Harnessing the Power of Counterintuition by Michael J. Mauboussin Harvard Business Press; 208 pp.; $29.95

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This index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names. Companies listed only in tables are not included.

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How Happiness Happens

The results of a new survey on satisfaction—at home and at work—may surprise you

Most parents will tell you they just want their kids to grow up to be happy (even if they're nudging them toward the Ivy League). But how does an adult achieve a high level of contentment while living a frenetic and distraction-packed life? The two of us have just reviewed results from our new survey designed to elicit insights into short-term satisfaction (happiness) and long-term benefit (meaning)—both at work and away from it. Our respondents weren't randomly chosen. They're well-educated (more than 60% have graduate degrees) managers, entrepreneurs, and professionals (split almost evenly between the sexes), numbering over 3,000.



Our findings were in many cases unexpected but clear-cut. There is an incredibly high correlation between people's happiness and meaning at work and at home. In other words, those who experience happiness and meaning at work tend also to experience them outside of work. Those who are miserable on the job are usually miserable at home.

The implication is unmistakable. Since work and home are very different environments, our experience of happiness and meaning in life appears to have more to do with who we are than where we are. Rather than blaming our jobs, our managers, and our customers—or our friends, family members, and communities—for our negative worklife experience, we might be better served by looking in the mirror.

One commonly expressed excuse for not getting more happiness and meaning out of life is: "I'm working too many hours." But our results show that the number of hours worked had no significant correlation with happiness or meaning experienced at work or at home. So much for that excuse.

Part of our survey asked respondents to rate their overall satisfaction level at work. Again, our findings paint a clear picture. The amount of time respondents spent solely on stimulating activities (high short-term satisfaction but low long-term benefit) had no bearing on their satisfaction at work. The same was true of more purposeful activities (low short-term satisfaction but high long-term benefit). Overall satisfaction at work increased only if both the amount of happiness and meaning experienced by employees simultaneously increased. This indicates that professionals don't gain satisfaction at work either by being "martyrs" or by "just having fun." Companies may want to reduce communications designed to encourage employees to make sacrifices for the larger cause. They may also want to cut out "fun" morale-building events that lack a meaningful purpose.

We had (mistakenly) guessed that those who spent more time outside of work in activities that produced more short-term satisfaction might score higher on overall satisfaction. After all, we assumed, people don't go home to find meaning; they want to relax. We were wrong. The correlations between happiness, meaning, and overall satisfaction at work and home were very similar. Those who were more satisfied with life outside of work were the respondents who reported spending more time on activities that produced both happiness and meaning.

These links between how we spend our time and how we feel may seem confusing, but specific patterns arose—some commonsensical, some not. Here are a few quick takeaways from our initial research:

- Reduce TV watching. It's stimulating but doesn't increase overall satisfaction with life—at work or home.
- Cut back on surfing the Web for nonprofessional reasons. It's negatively correlated with the experience of both happiness and meaning.
- Do as few chores as you can (whatever that word means to you).
- Spend time exercising and with people you love (respondents who did this had more satisfaction with life at work and at home).
- Feeling challenged is linked to greater satisfaction, so challenge yourself.

What can companies do differently? They might stop asking, "What can the company do to increase employees' experience of happiness and meaning at work?" which encourages dependency. Instead, managers can encourage employees to ask themselves, "What can I do to increase my experience of happiness and meaning at work?" This strategy may produce a higher return in employee commitment—and do so at a lower cost. |BW|

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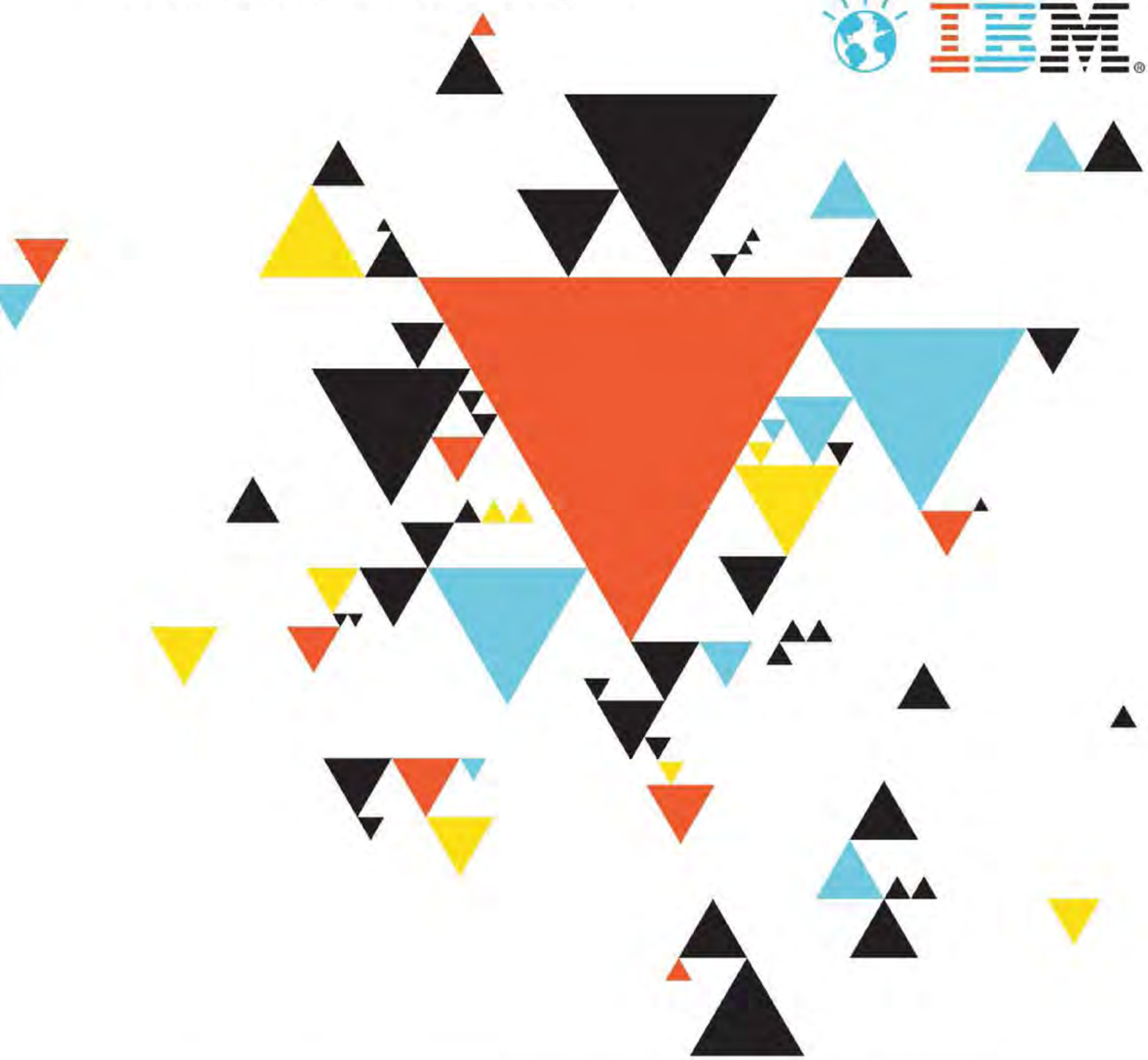
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